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CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1988

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ECONOMICS

JANUARY 7, 1987 }
JANUARY 8, 1987 } VIEWS OF THE REAGAN ADMINISTRATION

JANUARY 28, 1987—VIEWS OF THE CONGRESSIONAL BUDGET OFFICE

FEBRUARY 24, 1987—VIEWS OF THE FEDERAL RESERVE SYSTEM

COMPETITIVENESS AND TRADE

FEBRUARY 26, 1987

I

Volume I of IV

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ECONOMICS

WEDNESDAY, JANUARY 7, 1987

U.S. Senate,
Committee on the Budget,
Washington, DC.

The committee met, pursuant to notice, at 10:07 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Lawton Chiles (chairman of the committee) presiding.

Present: Senators Chiles, Hollings, Johnston, Sasser, Riegle, Exon, Lautenberg, Simon, Sanford, Wirth, Fowler, Conrad, Dodd, Domenici, Kassebaum, Symms, Grassley, Quayle, and Rudman.

Staff present: Richard N. Brandon, staff director; and Alan Cohen, assistant director for budget priorities.

For the minority: G. William Hoagland, staff director; and Gail Fosler, deputy staff director and chief economist.

Chairman Chiles. The committee will come to order.

Before we begin today, I want to take just a moment to comment on the changes in the room. For one thing, I want to make it clear that the Democrats have changed sides; they have not changed parties as some people had predicted.

Secondly, I want to commend the former chairman of the committee, Senator Domenici, for his 6 years of outstanding service. It is certainly going to be a tough act to follow.

In fact, I have been asked over and over again how I feel taking his place as chairman. I think it is a little bit like the new football coach who returned after 6 years away from the game. It turned out his first game was against the number one team in the country. He said, "Well, this is not a catastrophe." He said, "It is an opportunity disguised as an impossible situation."

To be honest, I think there are plenty of possibilities, and as I look around the room, I see eight new opportunities, eight new fresh perspectives. I want to welcome to our committee and, I might add, to the United States Senate, Senators Terry Sanford, Tim Wirth, Wyche Fowler and Kent Conrad. And then I certainly want to welcome some Senate veterans as new members of the committee: Senator Chris Dodd, Warren Rudman and Don Nickles. We are delighted to have you all be members of our committee.

OPENING STATEMENT OF CHAIRMAN CHILES

Chairman Chiles. Dr. Miller, we want to welcome you to the Budget Committee. We are delighted to have you come and present the President's budget. While every part of the budget has special importance, it seems to me that this year we want to lock into a vision of the future, and not be distracted from it by background noise.

REBUILD AND REASSERT ECONOMIC POWER

Our guiding principle, I think, has to be no less than rebuilding and reasserting economic power. Though the year is young, you may have already heard me say that before. But you can expect to hear me say it again.

Economic power is the ability to deliver a rising standard of living on a sustainable basis. To do that, we have to make investments in the future if we mean to excel in world economic competition.

We have got to stop borrowing from the future to feed today's appetites. To make those investments, I think we have to make room for them in the budget. That means we will have to erase the deficit with a prudent mix of spending cuts and revenues.

Dr. Miller, I am encouraged to see that the administration's budget includes a plan to double the funding for the National Science Foundation over the next 5 years. I congratulate you on that. It is rewarding to find that the administration is listening to what some of us Democrats and Republicans have been saying for years in the Congress after some of your earlier proposals cut funds in this area.

What puzzles me a little bit is while you are making modest investments in research and technology, you are reducing investment in people who would be able to expand and apply that research. Your budget cuts education funding overall by some 30 percent. I wonder where we are going to get the engineers and the science-minded people to keep building for our future.

MORE REVENUES NEEDED

As I look through your budget, I notice you have been listening to others as well. Countless private economists and many in Congress from both parties have been saying the deficit is too large to be eliminated by spending cuts alone.

You deserve further congratulations for coming to the same conclusion. Working off the CBO Baseline, your budget calls for roughly $34 billion in net savings. Of that, only $11 billion of that $34 billion—less than a third—comes from spending cuts.

As I notice from the President's proposal, you have $19 billion in nondefense spending cuts, but then you have $8 billion in spending increases in defense. So you end up with net spending cuts of $11 billion, and then twice that, $22 billion, comes from revenues. That seems to be an indication of a new realism in your approach.

This past Sunday when we appeared on Meet The Press, you said you could accept more revenues, that it was just a matter of the type of revenues. That tells me the administration may be ready to dig into the deficit. But when I look at the revenues you prescribe, there seems to be an emphasis on user fees and asset sales. You would end up with a combination of revenues that, one, are temporary and don't reach the structural deficit, and, two, affect only certain people.

It is true those are revenues, but they are selected revenues. They are partial, targeted revenues touching only a handful of areas while the deficit is a national problem. So although you are looking at the world through new glasses, I am not sure that you have found a 20/20 prescription as yet.

As we have come to expect, your budget also includes a number of spending changes, somewhat less in certain areas but considerably more in others. I wonder about the mix.

When we talk about types of revenues, I look in the budget and I see types that bother me.

For example, FHA user fees would mean an out-of-pocket increase to home buyers of as much as $1,600. That is a pretty stiff increase. In fact, if you applied that to every taxpayer, we would reduce the deficit by $160 billion this year. I am not suggesting that we do something like that, but I have to wonder why some are singled out and others are not. Don't we not need a fairer way to share that burden.

SPENDING SIDE OF BUDGET IMBALANCED

There is a further imbalance in the budget on the spending side. Your budget calls for $19 billion in domestic spending cuts, while spending $22 billion more than last year on the military, which adds about $8 billion to the deficit by way of outlays.

I think the case is closed on the debate over a strong national defense. We all agree that we need it. But we will have to take a long, hard look at the spending mix, the state of the economy, and the strength of our defense before we make any final decisions.

Dr. Miller, I do not doubt your concern about the size of the deficit, but I do doubt your estimate of its size. Your budget implies that, to reach the Gramm-Rudman-Hollings deficit target this year of $108 billion, we need to save $42 billion.

Adjusting for your $8 billion increase in military outlays, you would be down to $34 billion net. The Congressional Budget Office tells us, however, that that figure should actually be some $27 billion higher.

I think we can look at the charts there. The real gap is $61 billion to meet the Gramm-Rudman-Hollings target.

The President's Budget Proposal

(In Billions of $)

	1988
CBO Baseline Deficit for 1988	−169
G-R-H Target	−108
Savings Gap	− 61
President's Proposals:	
Spending Changes:	
Defense Spending Increases	+ 8
Nondefense Spending Cuts (Net)	− 19
Total Spending Reductions	− 11
Revenue Changes:	
Revenues	− 6
User Fees	− 3
Loan Asset Sales	− 6
Privatization Proposals	− 5
Other	− 2
Total Revenue Changes	− 22
Interest Savings	− 1
Missing Deficit Reduction	− 27

Senate Budget Committee Staff, January 6, 1987

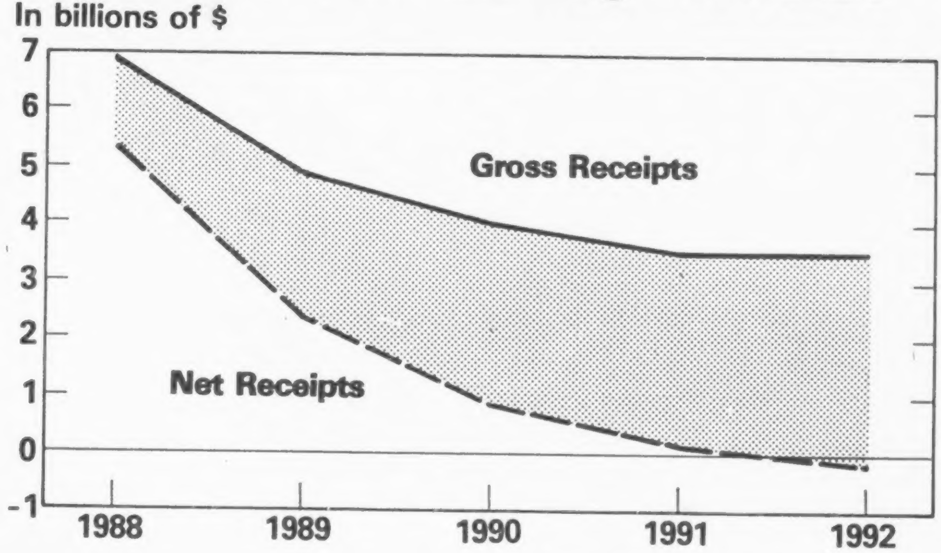
Composition of President's 1988 Proposal

(In Billions of $)

	Total	New Permanent Savings	One-Year Savings	Previously Rejected Savings
Spending:				
Defense	+ 8.0	+ 8.0	—	—
Domestic	−19.0	− 2.0	—	−17.0
TOTAL	−11.0	+ 6.0	—	−17.0
Revenues	−22.0	−10.0	−10.0	− 2.0
Interest	− 1.0	—	—	—
TOTAL	−34.0	− 4.0	−10.0	−19.0

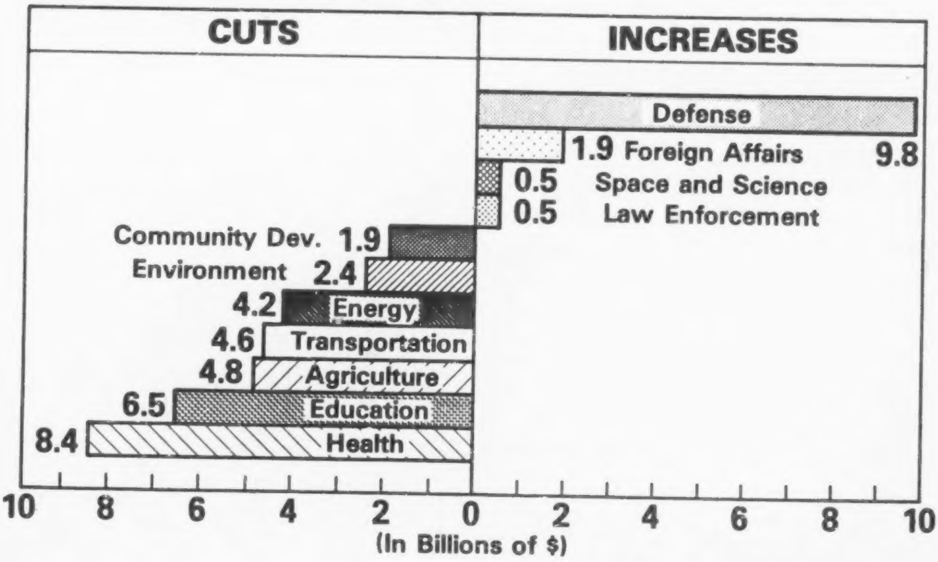
Senate Budget Committee Staff, January 6, 1987

Deficit Impact of President's Loan Sales from Existing Portfolios



Senate Budget Committee Staff, January 6, 1987

Spending Priorities in the President's Budget



Senate Budget Committee Staff, January 6, 1987

So we have got to pin down the size of the job before we proceed. The President's proposal includes savings of $34 billion in total, $11 billion in spending reductions, and $22 billion in revenue increases, $1 billion in interest savings. Of this amount, only $4 billion is in new permanent savings.

Looking at the new permanent savings in Line 2 of the chart over here, we have $10 billion in savings from revenues; we have a net of $2 billion in savings on spending programs. But when we deduct that from the $8 billion in new revenues for defense, we end up with $6 billion in new spending. Then, when we take the $10 billion off of savings and revenues, we end up with a net of $4 billion.

The remaining $30 billion in savings is achieved by $10 billion in onetime only savings, primarily loan and other asset sales, and $19 billion in savings proposals which have been considered by the Congress before and have been rejected at least once.

DEFICIT IMPACT

Going to the next chart, let's look at the deficit impact. In the President's loan sales from existing portfolios, we see that gross receipts from the sale of loans will range from $6.9 billion in 1988 to $3.5 billion in 1992 under the President's proposal. But then interest and principal repayments that the Government will no longer receive because it has sold the loans are going to range from $1.6 billion in 1988 down to $3.7 billion in 1992. So the end result is that the President's loan sale proposal will increase the 1992 deficit by $247 million—the difference between the $3.5 billion sold and the $3.7 million lost. And it looks like beginning in the year 1990, you lose any impetus from the loan sales because you are not picking up much in the way of revenue from that time.

SPENDING PRIORITY

I think we can go to the next chart then and look at the spending priority. The President's proposal significantly increases the defense and foreign aid programs, and then modestly increases the space and science programs and law enforcement programs. Those increases are made at the expense of the domestic programs, as has been in the case of each of the previous budgets. And we see those programs going from outlays: health about 7 percent of outlays; education about 32 percent of the outlays; agriculture about a minus 17 percent; transportation, 16 percent; environment, 50 percent; regional and community development, about 26 percent.

SIZE OF JOB MUST BE DETERMINED

So I think that we have got to pin down the size of the job before we can proceed. We cannot lose sight of the fact that some gymnastics with the arithmetic to reach this year's target will not help if we do not reach our ultimate goal of eliminating the deficit altogether.

I have heard the story about the employer who hired somebody to cut wood. The new employee sat down and started tapping on the log with the back of his axe and said, "I am not cutting, and I am not cutting." It came around to Friday, and the employer said, "You ain't been cutting, and I am not going to pay."

I think we have not been cutting and we have not been paying. We now find it is the time we are going to have to do some cutting and some paying to pur this together.

I repeat what I have said before: We welcome the chance to sit down with the President and to try to work under his leadership to revise this first budget draft. I think there are a lot of choices to make. I think there are some real opportunities to come up with a plan that would show the country we are serious and that we can come to a balance within 5 years. At the same time, we could start on some of these priority items to move this country forward and reassert our economic power.

Senator **Domenici**. Thank you very much, Mr. Chairman. It is my turn?

Chairman **Chiles**. Yes, sir.

OPENING STATEMENT OF SENATOR DOMENICI

Senator **Domenici**. Awhile ago, before most of the members arrived, I handed the gavel over to you. Let me do that in a more serious vein.

It is obviously a pleasure and a privilege to work with you. While it is with reluctance that I yield the chairmanship, it is with some degree of relief. I understand now that you have the responsibility, basically, of producing a budget. We will try to help you.

When we look back at how much you helped us in the past, it looks like a tossup: about half the time you helped and about half the time you did not. I do not know which way it will be this year. I assume that if we help you, we will work very closely together and try to come up with something that we can pass and that meets the test. If it is the half when we do not help, then good luck to all of you because you will all have to vote for something.

That will be an interesting exercise to all of you and it will be a lot of fun for me.

I welcome all the new members. Well, it will be fun. I do not know about the politics of it. We took the heat for a while. So now maybe it is your turn.

Senator Exon, it really is great to look down at the end of the table and see Senator Wirth instead of you. [Laughter.]

I saw you there for so many years and never called on you. [Laughter.]

Not only are you up here close now, but you have your own chairman.

But it was not so bad even when you moved up a seat and we put that new fellow from New Jersey down at the end. Frankly, he pushed harder than you, and for a freshman he got recognized a lot more than you. I really do not know why; maybe that is just the New Jersey in him as compared with the common old middle America Nebraskan.

Well, Mr. Chairman, I have a lot of remarks, and I do not know after what I have said if I am going to give them in full, other than to say that I do not really believe the President's budget as it is presented here by Mr. Miller is irrelevant to the work of this committee. I do not think so at all.

PRESIDENT'S BUDGET MEETS DEFICIT TARGET

Frankly, I believe that the President has submitted a budget that meets the $108 billion deficit target. There are those who would argue that it really did not. Let me suggest we still do not have an official reestimate of this presidential budget by CBO. Nobody should think that we do. We have some very preliminary information only.

CBO has given the majority some preliminary numbers, but the basic differences in the two budgets in terms of numbers are not blue smoke and mirrors, as some might have suggested in the past. There is an economic growth differential, but I think it is within limits. I do not think anybody is suggesting that the President's economic advisers have come up with some economics that are, you know, over the top of the building. It seems to me they are within the ball park.

There is a difference of opinion on a couple of other issues, such as farm subsidies. There are functions about how you treat the advance deficiency payments; do you put them in now or not? That is a pretty sizable number. But suffice it to say, using the President's economics and his approach to government, the administration has done something very important. They have reached $108 billion. That is our target; that is our goal. Unless and until the law is changed, we cannot act otherwise, as I understand it, without a two-thirds vote.

Also, without going into detail, you cannot get to $108 billion without some pain. Anybody that thinks you can is wrong. The President has administered pain in one way. We do not like it, some of us. No matter how we get there, it is going to be tough. Without pain, we will not get there. There is no easy way.

I am not sure I like the President's approach to Medicare and Medicaid, but let me suggest, theoretically, they are on the right track because it is a major entitlement program. I do not see how we will get to the target without some reform in entitlements.

The administration has also suggested that farm subsidies in the out years be reformed significantly. That is an entitlement of sorts. We are going to have to get some reform. Maybe we will do it without any entitlement reform, but I do not think so.

CBO'S EARLY ESTIMATES DISTURBING

Now, last but not least, let me say that something about the CBO's early estimates disturb me greatly. Let me suggest what they are. There are three very simple things.

First, defense spending is going to grow at only 3.7 percent in 1988, and that is CBO's early-on baseline estimate. Maybe that is too much for some. For this Senator, it seems about right. Frankly, we will not be to the 1985 Presidential request of defense with this fiscal year 1988 defense number that is sought by the President. That means there has been 2 intervening years when there has been negative growth in defense. In other words, in literal terms defense is down, not up, and we are not even catching up to the 1985 request with this.

But, nonetheless, take the number, 3.7 percent growth. Interesting. CBO shows entitlements growing at 6.5 percent. And a real shocker: they have nondefense discretionary spending growing at about 11.4 percent. For all of you that think we had discretionary spending under control, I believe we have got to get some information out of CBO and OMB. How in the world are we at 11.4 percent growth in their baseline?

I understand about 4 percent is inflation, but where does the rest of it come from? It seems to me that somehow or another, when we start deliberating this, we have to discuss our starting point. When we talk about cutting, let us understand now that we start with a CBO baseline and we are cutting off of it.

I am going to suggest, just for purposes of our own observations, that we ask CBO to give us a budget option; that is, a literal freeze. Then CBO should come and tell us what spending has to go up by law. Maybe this would be a better starting point for us than their current policy baseline, which seems to me to be a dramatic turnaround. We thought we were making headway on the domestic side; now we see it has gone back up.

Having said that, Mr. Chairman, I look forward to working with you and the new members. I welcome all the new members on your side. On our side, we have two new ones. They are kind of seasoned veterans, and we welcome them.

You note that I have my good right arm. In the event we are thinking about not following Gramm-Rudman-Hollings, we have brought Sen. Rudman up here. And I do not know if Senator Hollings will be here? So we will call it Hollings-Rudman-Gramm; is that right? [Laughter.]

Thank you, Mr. Chairman.

Chairman Chiles. Thank you, Mr. Chairman. I appreciate your remarks and especially the kind statement that you started with.

It is sort of strange how memories work. I listened to your recollection that about half the time we helped and half the time we did not. My recollection is about half the time we got asked to participate and the other half we did not. [Laughter.]

Memory has a great way of affecting us that way, I guess.

Senator Domenici. Right.

Chairman Chiles. But we want to invite your help sort of on a hundred percent basis. We look forward to that.

Senator Domenici. Well, Mr. Chairman, when we did not ask for your help, we concluded that you could not go along with us.

Chairman Chiles. I see. I see. Then the majority gets the choice to conclude?

Senator Domenici. That is right.

Chairman Chiles. All right. We will be following the early bird rule. Those that were actually here at the beginning, go first. So under that, Senator Conrad, you are going to be the first one to question. I am going to waive my questions. You will get a chance to open.

Senator Conrad. Well, Mr. Miller, you know I come from North Dakota, a farm state. I am sure you know we have a crisis in agriculture. I see in the budget proposal a reduction for agriculture. In fact, agriculture has one of the steepest reductions in this proposal.

I am wondering what the plan is of the administration to do something——

Chairman CHILES. Wait, I forgot. We should allow Dr. Miller to start here. I am not used to this being chairman. Before we question him, maybe we ought to just give him a shot at making his opening statement. [Laughter.]

Senator CONRAD. I was going to give him a shot, Mr. Chairman. [Laughter.]

Chairman CHILES. I first will say, does anybody feel called upon to make an opening statement?

Senator LAUTENBERG. We almost have to rebut the exchairman's comments, but with him not here it would not be fair.

Chairman CHILES. All right. Well, Dr. Miller, we will call on you, then.

Dr. MILLER. Thank you, Mr. Chairman. I do appreciate the opportunity to have a trial before the execution. [Laughter.]

Senator CONRAD. I am not leaving because I do want to hear.

STATEMENT OF HON. JAMES C. MILLER III, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Dr. MILLER. Mr. Chairman, I want to express my appreciation for your remarks and those of Senator Domenici, and also for your getting the formal process started so quickly after the convening of the 100th Congress.

We in the administration worked very hard to submit the President's budget on time, a full month early, and we hope that you in Congress will maintain your schedule. And I must say this hearing is certainly a good beginning.

Speaking of completing the budget a month early, I want to thank my colleagues in the OMB for their extraordinary efforts in meeting this deadline, and thank the various officials in the agencies for their efforts as well.

I want to apologize to you Members of Congress and also members of the media for not having the full contingent of documents that we usually have at this time. We should be releasing those on January 28th.

EVALUATE PRESIDENT'S PROPOSALS ON THEIR MERITS

Now, Mr. Chairman, we in the administration want to work with you and your colleagues in the Congress and in this committee. We believe, however, that, in turn, Members of Congress should evaluate the President's proposals on their merits rather than criticize the President's budget as some have done before even the ink was dry.

We also believe this means that Members of Congress Should evaluate closely and respond constructively to the President's proposals for reforming the budget process. Let us not miss an opportunity both to fashion a budget we can be proud of and to improve the budget process so that performances like that will be automatic in the future.

Mr. Chairman and members of the committee, today I would like to describe a few themes and details in the budget, go through the materials I submitted in advance which are displayed on charts that are about to be put up, and then answer your questions.

As with last year, the emphasis in this year's budget is on deficit reduction. The deficit dragon is not slain, but last year we extinguished the dragon's fire. This year we will cast a net over the beast to get more control of it. This is not Puff, the Magic Dragon. This is more like the slithery D. This is a dragon that can hurt us if we do not get control over it.

This budget contains a 3-percent increase for defense, but it contains no increase in taxes despite what some have said. We will go into that later, I am sure. And it contains no change in Social Security benefits.

FUND SOME EMERGING PRIORITIES

Now, one theme is to fund some emerging priorities; for example, drug enforcement, reducing supplies of drugs, preventing consumption of drugs, treating those who have drug problems; immigration reform, acid rain, clean coal, $350 million more for the Department of Energy. The FAA will increase 20 percent overall; a 68-percent increase for its modernization of the air traffic control system; infant mortality; AIDS research will exceed half a billion dollars; and we have initiatives for the homeless.

We also have a number of new programs, projects or approaches; for example, credit reform, and pay for performance for Federal Government employees. We have revisions in the farm bill that the Senator just mentioned. We have a 2-year budget for defense. We propose to give States and localities sufficient flexibility so that they may use funds that have been used in the past to finance summer youth programs to finance year long job programs for teenage AFDC recipients.

INCREASE KNOWLEDGE AND EDUCATION

Another theme is to realize a more productive, more competitive American; for example, to increase knowledge and education, we will double the NSF research budget in 5 years. We will increase the Department of Defense and NASA basic research by $7 billion.

We will reform education by making more unobstructed guaranteed loans and less subsidized loans. They will be availible to students to use at any school they like. We will provide income contingent loans for the financially disadvantaged. Under this program, if people get into the job market and find their income is not as high as anticipated, their scheduled repayments will be stretched out.

It will make the private sector and the economy grow generally more efficient by increasing our efforts to improve technology transfer by privatizing some commercial types of Government activities, and generally being less intrusive with Government regulation, where this is possible. We will make government do its part by increasing productivity and by charging for specific services, including loan fees.

REFORM HEALTH CARE PROVISIONS

And still another theme is to reform the provision of health care in this country. For example, we propose a reform in the way Medicare pays radiologists, anesthesiologists, and pathologists. Although it doesn't save a lot of money, it begins moving toward capitation, an administration goal.

We would stretch the Medicare payment cycle from 26 days to 30 days. We would remove disproportionate share hospitals from the periodic interim payment system. We would expand coverage of Medicare to State and local employees, most of whom become eligible for Medicare but haven't paid for it. It's not fair to the rest of the citizens. We would increase Part B premiums from 25 percent to 35 percent for new Medicare, but not for existing Medicare, recipients.

We would reform medicaid by reducing State support by $1 billion, and by indexing support in future years the medical inflation index. We would suggest to States that they move toward capitation and we would provide incentives for them to do that by sharing some of the saving with them We also have some regulatory reforms.

In VA we would guarantee medical care to those veterans who have an injury or illness connected to their service in the military. We would also guarantee service to veterans who contracted a disease or have a disability so long as their income is below $20,000 or $25,000 in case of a married couple. But we would not do quite as much in terms of the so-called excess capacity to accommodate others, many of whom have health insurance policies or Medicare that they could go to.

Now, Mr. Chairman, if you will, I would like to describe briefly some of the major parameters of the President's budget with the help of these charts, and then I will be more than happy to respond to your questions.

PRESIDENT'S FY 1988 BUDGET
(in billions of dollars)

	Fiscal Year						
	1986	1987	1988	1989	1990	1991	1992
Totals:							
Receipts	769.1	842.4	916.6	976.2	1,048.3	1,123.2	1,191.2
Outlays	989.8	1,015.6	1,024.3	1,069.0	1,107.8	1,144.4	1,178.9
Deficit or surplus	−220.7	−173.2	−107.8	−92.8	−59.5	−21.3	+12.3
Gramm-Rudman-Hollings targets	−171.9	−144.0	−108.0	−72.0	−36.0	0.0	0.0
Year-to-Year Changes:							
Receipts	35.0	73.3	74.2	59.6	72.1	74.9	68.1
Outlays	43.5	25.8	8.8	44.6	38.8	36.6	34.5
Deficit	−8.5	+47.5	+65.4	+15.0	+33.3	+38.2	+33.6

As I indicated, Mr. Chairman, this budget meets the 1988 deficit target of $108 billion. This requires a year to year reduction of $65 billion in fiscal year 1988 following a reduction of $48 billion in fiscal year 1987. As you know, the deficit came in for fiscal year 1986 at $221 billion. Both CBO and OMB estimate the fiscal year 1987 baseline deficit to be $174 billion. So, from 221 billion in fiscal year 1986 down to $174 billion in fiscal year 1987 is a remarkable bit of progress. And I think praise goes to Senator Rudman and to others who have been engaged in generating this proposal that a bipartisan Congress endorsed just over a year ago.

NATION'S TAX BURDEN NOT INCREASED

This budget does not increase the nation's tax burden. It reflects a bipartisan consensus to protect social security. It provides 3 percent real growth in national defense, that's 3 percent over the appropriated level, and it reforms or reduces or terminates a number of programs that will save $19 billion in fiscal year 1988 alone.

Senator DOMENICI. Mr. Chairman, could I ask a question?

Chairman CHILES. Yes, sir.

Senator DOMENICI. Mr. Miller, when you were explaining line No. 1 there, you said both CBO and OMB for 1988 have a deficit going from 22 billion down to $170.

Is that a true statement? Did both of you have the baseline that high?

Dr. MILLER. If I said exactly what you said, I misspoke.

Senator DOMENICI. You did?

Dr. MILLER. I misspoke. I meant 1987. Both OMB and CBO estimate the fiscal year 1987 deficit at approximately $174 billion. We did not collude. It was pure coincidence. Obviously for 1987, brilliant minds work alike.

Senator DOMENICI. You did say that.

Dr. **Miller**. For 1988 and thereafter.

Senator **Domenici**. Indeed, you said that. I misunderstood you. You're correct. I apologize.

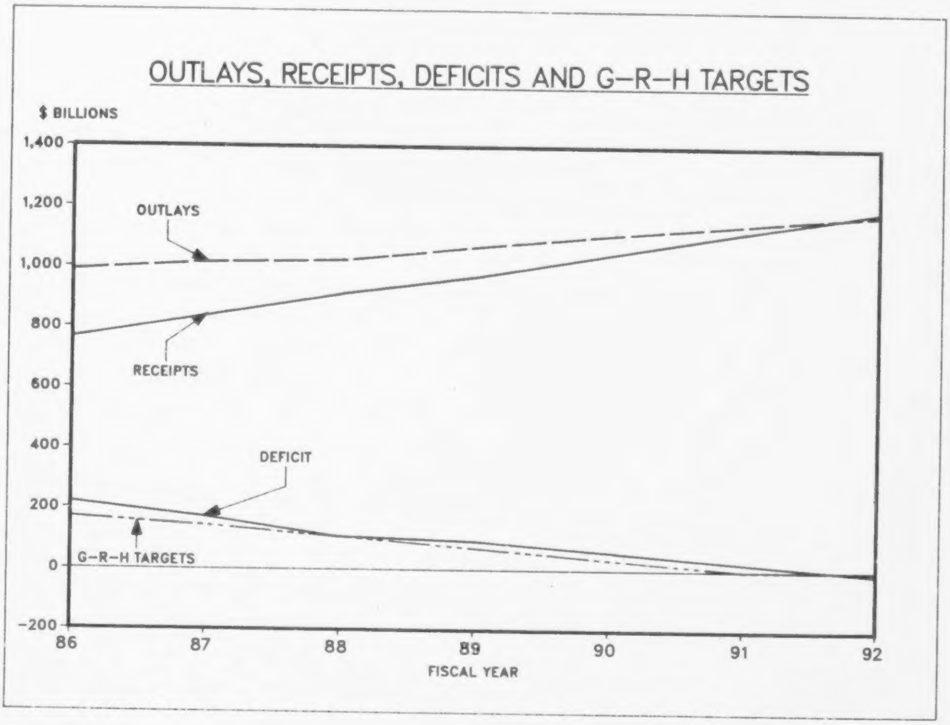
Dr. **Miller**. No. That's fine, to clear this up.

The President's fiscal year 1988 budget contains receipts of $916.6 billion and outlays of $1024.3 billion.

Now, if I could just put in perspective what a trillion is. My understanding is that if on that day the Christ was born, there was a box of money containing a trillion dollars, and someone had begun spending a million dollars a day out of that box, they would still have 754 years to go before exhausting that box.

Senator **Johnston**. Is that the deduct box? [Laughter.]

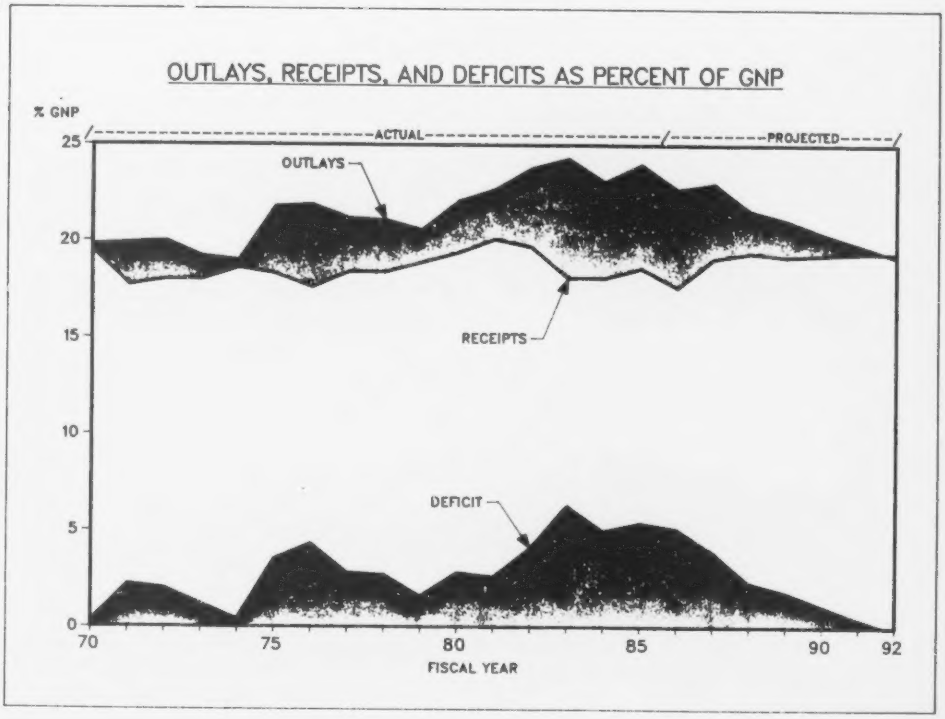
Dr. **Miller**. The President's budget deficit for fiscal year 1988 is $107.8 billion. As you can see, there is a $74 billion increase in total revenues from 1987 to 1988, and $8.8 billion increase in outlays.



This chart shows the receipts line continuing to go up over the period of 1986 through 1992, outlays increasing at not so rapid a rate through 1988 and increasing at a little more rapid rate thereafter.

SHORTFALLS NEED MORE WORK

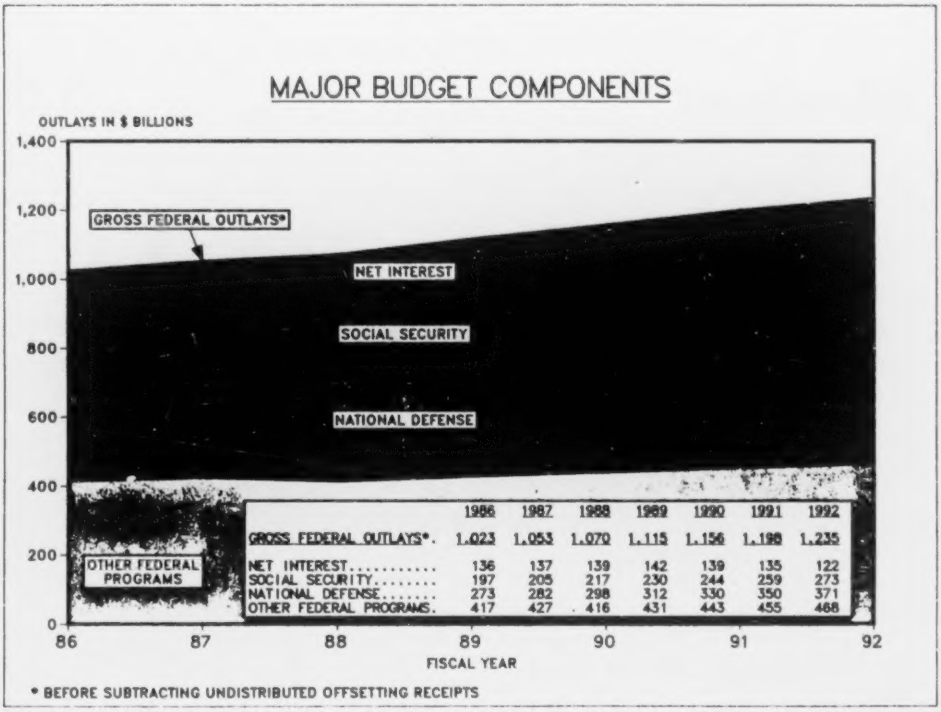
The broken line is the Gramm-Rudman-Hollings targets, the solid line is the deficit. As you can see, we hit it here for 1988, but are slightly above it for the outyears, which means that we will have some more work to do, even if you adopt the President's budget. But the shortfalls are about $20 billion.



OUTLAYS, RECEIPTS, AND DEFICITS AS PERCENT OF GNP

This chart indicates outlays, receipts and the deficit as a proportion of gross national product. And as you can see, the receipts have been reasonably constant, more so than outlays. Outlays took a very big rise in the mid-1980's and began to taper off, and we anticipate their tapering off some more as a proportion of gross national product.

The deficit reached a peak in 1983 as a proportion of gross national product and also in real terms. It decreased in 1985. It rose slightly as a proportion of gross national product in 1986. It will be down sharply for 1987 and down again under this budget for 1988. If we hit the $108 billion target, we will have reduced the deficit from $221 billion in fiscal year 1986 to $108 billion in fiscal year 1988, That is cutting the deficit in half, and I think that is remarkable progress.



MAJOR BUDGET COMPONENTS

	1986	1987	1988	1989	1990	1991	1992
GROSS FEDERAL OUTLAYS*.	1,023	1,053	1,070	1,115	1,156	1,198	1,235
NET INTEREST...........	136	137	139	142	139	135	122
SOCIAL SECURITY........	197	205	217	230	244	259	273
NATIONAL DEFENSE.......	273	282	298	312	330	350	371
OTHER FEDERAL PROGRAMS.	417	427	416	431	443	455	468

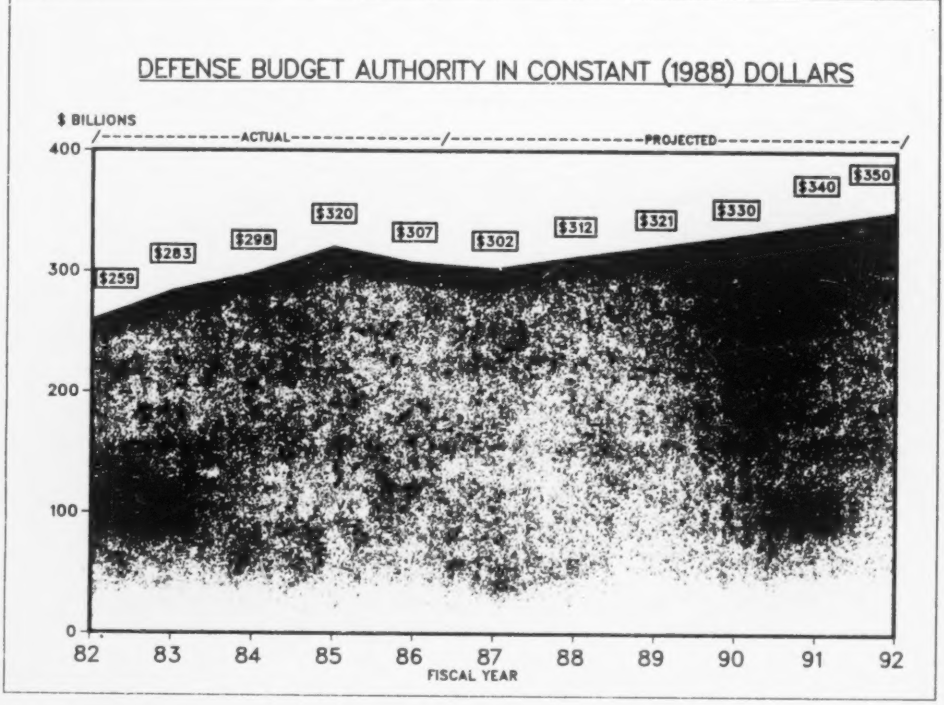
* BEFORE SUBTRACTING UNDISTRIBUTED OFFSETTING RECEIPTS

What we have done here is divide the budget up in major components. Net interest we really can't do anything about unless we want to declare bankruptcy. There is a bipartisan understanding about social security that I need not go into.

THREE-PERCENT REAL GROWTH IN DEFENSE

In national defense, the President has been very insistent, and appropriately so I believe, to maintain a 3 percent real growth in defense over the appropriated level.

And this goes to the point that Senator Domenici was mentioning awhile ago. This chart represents defense budget authority in constant 1988 dollars, and it has risen from $259 billion in budget authority from 1982 to $320 billion in fiscal 1985. That is in 1988 dollars. In the two subsequent years, defense budget authority fell in real terms from $320 billion to $307 billion and to $302 billion last year.



DEFENSE BUDGET AUTHORITY IN CONSTANT (1988) DOLLARS

The President proposes raising that to $312 billion this year and in real terms to $321 billion next year. In other words, it will take 2 years to catch up with defense where we peak in fiscal year 1985 in real terms. So allegations that we continue to have a cushion of a big increase in defense are simply not true. We have tapered off defense for the past 2 years. It will take 2 more years just to catch up to where we were.

Senator DOMENICI. Mr. Chairman, could I ask a question?

Chairman CHILES. Yes.

Senator DOMENICI. Is that $320 billion in 1985 appropriated budget authority?

Dr. MILLER. Yes.

Senator DOMENICI. What was the President's request that year?

Dr. MILLER. It was higher. I don't remember the amounts, but I can get it for you.

Senator DOMENICI. But it was higher?

Dr. MILLER. Yes, it was higher.

[The following was subsequently supplied for the record by OMB:]

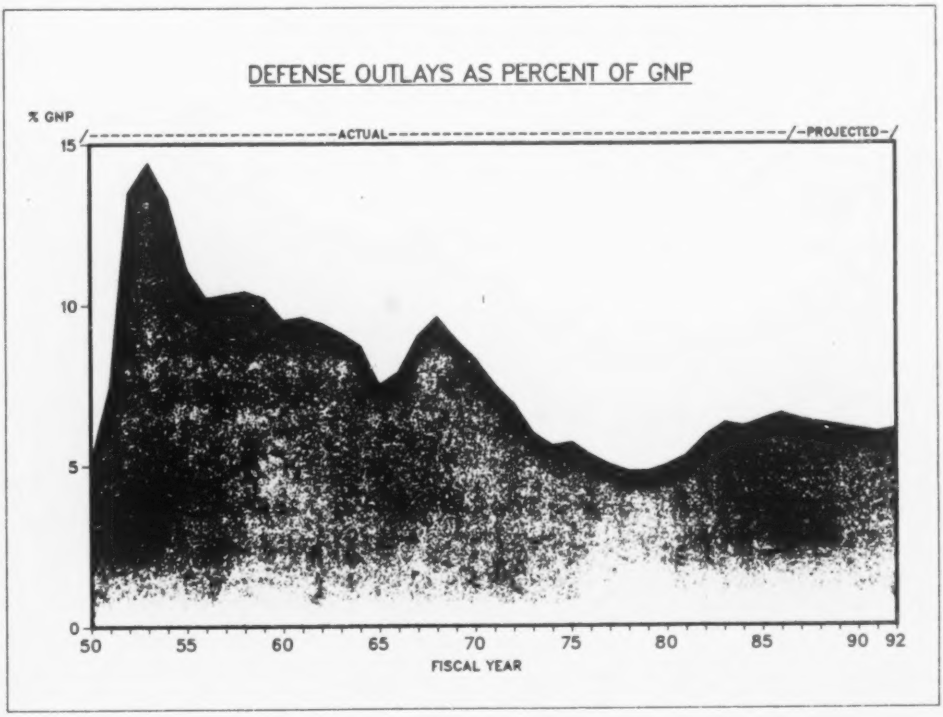
The President's 1985 Budget included a request for $313.4 billion of defense budget authority. The actual defense budget authority enacted for 1985 was $294.7 billion.

PRESIDENT ASKS FOR REDUCTION IN DEFENSE

Dr. MILLER. And as you remember, Senator Domenici, the President asked for $320 billion in budget authority in his budget last year for defense. And we are asking for only $312 billion for fiscal

1988, a $8 billion reduction from the request of last year, and a substantially greater reduction from the 1988 request that was contained in the 1987 budget.

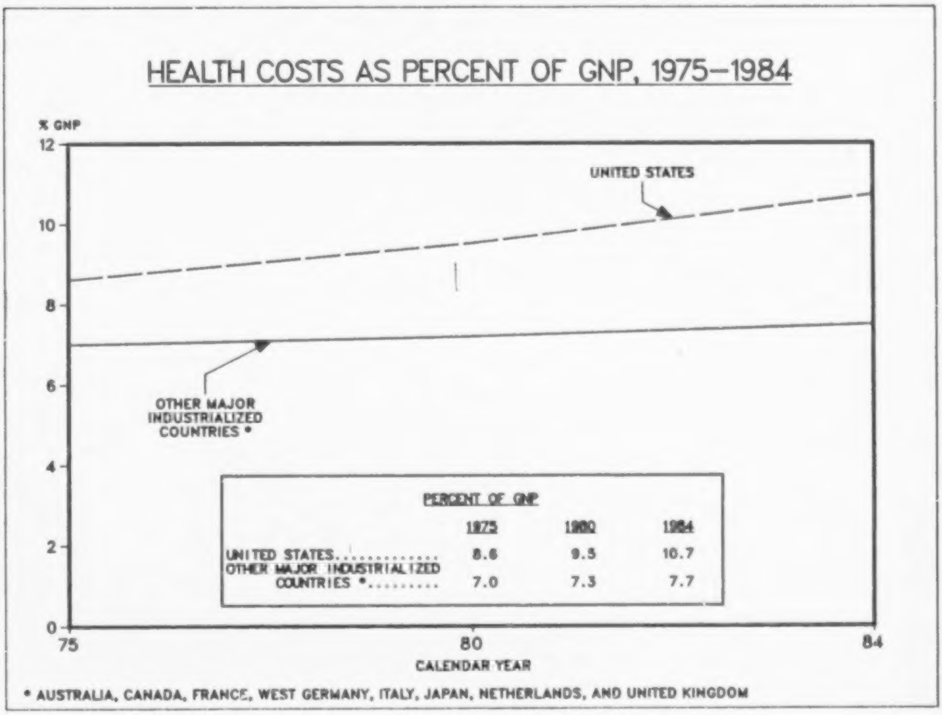
Mr. Chairman and members of the committee, this chart illustrates the proportion of gross national product that is being taken by defense spending over a period since 1950. And as you can see, of course, during the Korean War a very high portion of the gross national product was going for defense. It decreased, rose again during the Vietnam conflict, fell to rather substantially low levels in the late 1970's, and rose again.


DEFENSE OUTLAYS AS PERCENT OF GNP

The President's budget, as submitted, calls for a continuing decrease in the proportion of the gross national product that will go for defense. Now, Mr. Chairman, what we have then done is taken the part of the budget other than interest, social security and defense, and that is this line right here. We have a base in 1988 of approximately $448 billion, and this is where we will propose to make some programmatic changes that will save some outlays. We divided it into three categories: major medical programs, which are other mandatory programs, basically the rest of the entitlement programs, and then the nondefense discretionary programs.

EXPENDITURES IN HEALTH CARE INCREASING

A point that I want to make here, Mr. Chairman, is that the United States spends a great deal more on health care as a proportion of its gross national product than the average of other industrialized nations. Moreover, the rate of growth in that health care expenditure as a proportion of gross national product is much higher than it is in other industrialized countries.



PERCENT OF GNP	1975	1980	1984
UNITED STATES.............	8.6	9.5	10.7
OTHER MAJOR INDUSTRIALIZED COUNTRIES *.........	7.0	7.3	7.7

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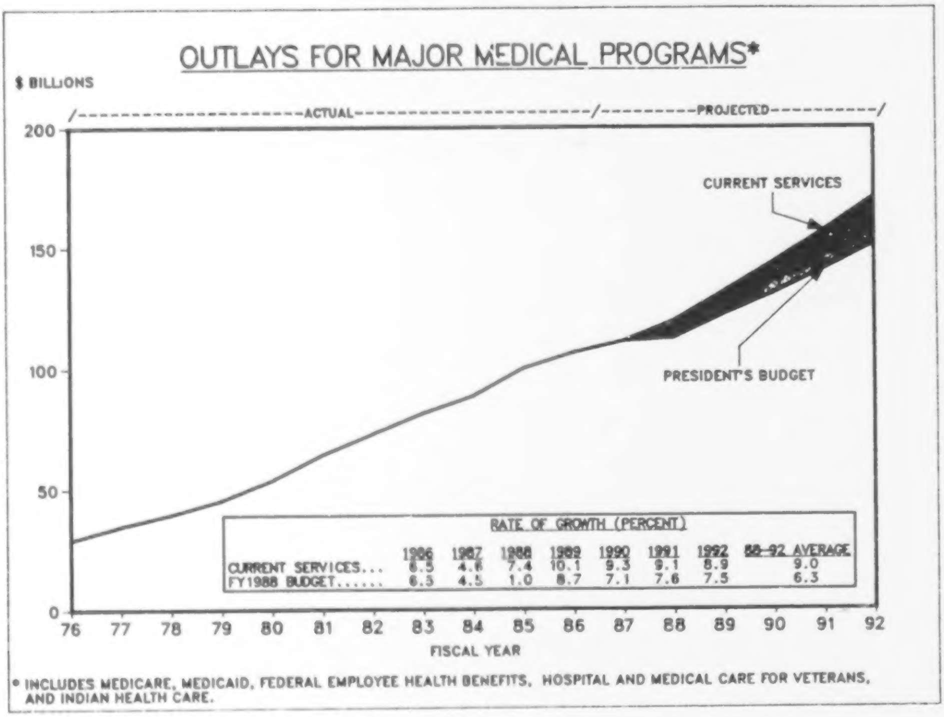
If you were to do this chart for Federal expenditures, you would see that the rate of growth in Federal expenditures on health are increasing at a much higher rate than total expenditures. This is a problem that I think we must come to grips with. We must stress.

Now, our outlays for major medical programs have continued to rise, and I am not playing tricks here, there's no scaling down of this. This is zero and this is 50, 100 and so forth. As you can see, outlays 1976 for major medical programs in the Federal Government have risen dramatically since 1976. And current services would have them continue to rise. But the President's budget would have them rather level off in 1988 and then increase again after that.



OUTLAYS FOR MAJOR MEDICAL PROGRAMS*

RATE OF GROWTH (PERCENT)

	1986	1987	1988	1989	1990	1991	1992	88-92 AVERAGE
CURRENT SERVICES...	6.5	4.6	7.4	10.1	9.3	9.1	8.9	9.0
FY1988 BUDGET......	6.3	4.5	1.0	8.7	7.1	7.6	7.5	6.3

* INCLUDES MEDICARE, MEDICAID, FEDERAL EMPLOYEE HEALTH BENEFITS, HOSPITAL AND MEDICAL CARE FOR VETERANS, AND INDIAN HEALTH CARE.

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We would propose making some changes here that we believe can reduce overall outlays, but maintain the benefits that now go to beneficiaries. There are no changes for the beneficiaries of Medicare. There are some changes in the Medicaid area and in the VA area, but by and large——

Chairman CHILES. You're saying the Medicare beneficiaries are not going to be paying more money?

Dr. MILLER. New Medicare beneficiaries would have their part B premiums raised from covering 25 percent of costs to 35 percent, but existing Medicare beneficiaries would realize no changes.

Now, the second area——

Chairman CHILES. So it's better off to be an old Medicare beneficiary than a new Medicare beneficiary. All of us pigs are equal, but some of us pigs are more equal than others.

Dr. MILLER. I wouldn't contest your statement, Mr. Chairman.

SOME REDUCTIONS PROPOSED

If you look at the other entitlement programs, which include the Federal retirement, low income support, unemployment benefits, guaranteed student loans, the GI bill, farm price supports, et cetera, you will see a peak in 1983. This was caused by increases in farm price supports and unemployment compensation. As you can see, it has risen here slightly in the past year. We have proposed some reductions, and we can go over later what those reductions are.

Current services estimates assume price supports or payments to agriculture will go down. That's partly the reason that this goes down, not just the President's proposal. But then it would begin to rise again.

This is the final area. This is everything else in the budget. Increase here, fell again, peaked, and then current services show that the outlays would continue to rise at a fairly rapid rate. The President's budget would rather even out these outlays for nondefense discretionary programs. Rather than growing at 4 percent over the period 1988 to 1992, they would grow at only 1.1 percent.

And that, Mr. Chairman, I guess—no, we have some more.

Chairman **Chiles**. I would hope that we could terminate now so we would have an opportunity to ask questions. I think we have a number of them.

Dr. **Miller**. I only have three charts, and I will go very quickly, Mr. Chairman, at the chairman's pleasure. In fact, let's make a dramatic decision here and let's skip this chart. [Laughter.]

It's wonderful to be an executive. The point that I wanted to make——

Senator **Lautenberg**. It's an important chart, Mr. Chairman. If you don't mind, I'd like to see it.

Dr. **Miller**. Well, we'll put it back up.

Chairman **Chiles**. Why don't we wait until we get your questions.

Dr. **Miller**. So many of my decisions don't stick anyway, so I'm not surprised. [Laughter.]

TOTAL OUTLAYS REDUCED $18.7 BILLION

Well, what we have here are the data we will show in pie chart form in a moment. The data are available to you in the highlights book that I submitted to the committee. It shows that there is an $18.7 billion reduction in total programmatic outlays in the President's budget from current services, and it consists of $6.7 billion from the major medical area, $3.4 billion from the other entitlements programs, and $8.6 billion from nondefense discretionary programs.

SUMMARY OF DEFICIT REDUCTION PROGRAM
(change from current services, in billions of dollars)

	Fiscal Year					
	1987	1988	1989	1990	1991	1992
Programmatic Changes:						
Major medical programs	0.1	6.7	7.7	10.0	11.8	13.9
Other mandatory	0.1	3.4	8.2	11.4	13.1	13.9
Nondefense discretionary	0.7	8.6	15.0	19.3	24.2	27.3
Total, programmatic changes	0.9	18.7	30.8	40.8	49.1	55.1
Revenues Changes:						
Governmental receipts	0.1	6.1	8.0	8.6	8.8	8.9
Credit reform	—	1.3	0.6	−0.9	−2.2	−3.6
Other loan asset sales	—	4.2	1.7	0.8	0.3	*
Privatization	0.1	5.4	3.7	3.8	6.5	5.3
User fees	0.3	3.2	3.5	3.6	3.7	3.8
Other revenue changes	—	2.1	2.6	3.6	4.3	6.7
Total, revenue changes	0.4	22.4	20.1	19.5	21.5	21.2
Interest	*	1.3	3.2	6.0	9.3	14.3
Total, deficit reduction	1.3	42.4	54.2	66.2	79.9	90.6

*$50 million or less.

REVENUES INCREASED $22.4 BILLION

On the other hand, we have $22.4 billion in increased revenues. As you can see, we propose more increase in revenues than we have decreases in outlays in of the total package in $42.4 billion deficit reduction.

The chairman is correct in pointing out that the proportion of revenue in our deficit reduction program this year is greater than last year. But, Mr. Chairman, we did have about $15 billion last year in the same categories. We have here $6.1 billion in governmental receipts. All of this shows on the receipts side of the budgets. Part of that is an IRS initiative that will give IRS more enforcement resources, and they will collect more taxes due, raising about $2.4 billion. Part of it is that we are extending the requirement that employers pay social security on tip income as well as regular income. We think that current law is inconsistent on this point. Part of this is extending coverage of medicare to current State and local employees. As you know, it is already mandatory for new State and local employees to be covered by Medicare.

We have a net increase of about $1.3 billion in revenue from credit reform. There what we're proposing to do is sell new loans right after they're made, charge the agencies the difference between the loan that is made and the value received for the loan paper. That makes an implicit cost become an explicit cost, and I think the decisionmaking is better. At the same time, we're proposing to reinsure guaranteed loans. Because we're not reinsuring quite as many of the guaranteed loans in the first years of the program because the market has not developed well yet there is a $1.3 billion difference between receipts from asset sales and reinsurance costs, and that shows up as increased revenue.

We're selling $4.2 billion in old loan paper. We find that the private sector is able to collect those loans better than the Federal Government. We propose selling physical assets, privatizing Amtrak, which has most of its value in the Northeast Corridor. We propose selling the Naval Petroleum Reserve and a couple of other assets. We have $3.2 billion in user fees. These recover some costs for specific Government services that are given to identifiable individuals, and we think that it's appropriate for recipients to pay for them rather than to have people across the nation pay.

And we have finally $2.1 billion in other revenue changes, including sale of stock to stave off some problems in FSLIC.

So we have a total of $22.4 billion in revenues. Since the President's budget proposes outlay and revenue changes to achieve savings of about $43 billion, some savings on servicing the debt will be realized. In fact, we save an estimated $1 billion there for a total package of $44.2 billion.

Senator JOHNSTON. Mr. Chairman, may I ask?

Governmental receipts, are those what we call taxes?

PRESIDENT SUPPORTS SOME KINDS OF REVENUES

Dr. MILLER. No. I will explain in detail. But I do not count those as taxes. Taxes are, in my judgment and in the judgment of the President of the United States, for the purposes of raising revenue, in ordinary income tax, corporate tax, and that sort of thing. And the President has said no to those.

But proposals for the government to charge more cost based prices for things, where you have substantial inequities between say people in State and local governments who have access to Medicare but do not pay for it, those kinds of things he will go along with. He will go along with user charges. He will go along with privatization. In fact, he's very much supportive of privatization and the sale of assets.

Senator, by and large, the kind of revenues the President can support are those where you spin off activities of Government; one-shot deals that make Government leaner and grow smaller, or at least not increase in size. The kinds of taxes that we've been hearing about are increases that are permanent fixtures of Government, that will make Government grow larger. We have a current services deficit that is coming down, and we have a choice. We can by 1992 realize a balanced budget by having increased taxes and revenues for every year and thereafter you have a larger government.

Or you can do it by a combination of cuts in programs and some additional revenue of the one-shot variety that I talked about that ends, and you can realize a balanced budget by 1992.

ONE-SHOT DEALS

Chairman **Chiles**. Why do you have a larger government if all the revenue, whether it be taxes or one-shot deals, applies to the deficit? Why do you have a larger size of government?

Dr. **Miller**. Well, to the extent that you rely on increased revenue rather than reductions in outlays, whenever you get there——

Chairman **Chiles**. But if you are talking about a one-shot proposition, if you sell the Naval Petroleum Reserve, it's gone.

Dr. **Miller**. That's right.

Chairman **Chiles**. You haven't done anything that reduces the structural deficit. You have a one-shot deal. What's the difference—I'm just asking you theoretically now—tell me the difference between that and having that same amount of revenue come from some other revenue source even albeit a tax that you would call it.

Dr. **Miller**. The key difference, Senator, is that in subsequent years with a tax you would have additional revenues flowing in, and for any deficit target, you would have a larger government.

Chairman **Chiles**. No, no. Now, if the revenue had to apply to reducing the deficit, how do you get larger government?

Dr. **Miller**. Well, the point is that you have that extra revenue to apply to reducing the deficit. It means that you have not cut out something that you would have spent.

Chairman **Chiles**. But in the Naval Petroleum Reserve the next year you do not have anything different. You had a one-shot deal. If you sold a loan asset, you had a one-shot deal. You haven't cut out anything. Tell me the difference. Why does one affect the size of government and the other doesn't?

Dr. **Miller**. Very simply, Senator. If you have a government that owns an oil field in one case, and a government that doesn't own an oil field in the second case, I would argue that in the second case, the government is smaller.

Second, if you have taxes that are going to continue out in the future, it means that at that point in time you have a larger government. You have higher revenues.

Chairman **Chiles**. No; we started off saying those taxes had to apply to the deficit. They only could apply to the deficit.

Dr. **Miller**. Right.

Chairman **Chiles**. If it didn't apply to the deficit, you terminate them or you don't have them.

Dr. **Miller**. Right. Well, the only way you can make the President's proposal and yours equivalent is that those taxes expire at the time the deficits balance.

Chairman **Chiles**. Ah, there you have the status of a deal I think. [Laughter.]

EFFICIENCY AND SIZE ARE DIFFERENT

Dr. **Miller**. There's a question. But I would say, Senator, there's a big difference in efficiency of the Government, and it's also a difference in the size of the Government, if you finance that revenue by absence of Government rather than by tax increases.

Chairman **Chiles**. Tell me what efficiency of government you get if you sell off a loan portfolio?

Dr. **Miller**. Well, for one thing, you have increased the value of that loan asset to the taxpayer because the Federal Government is more efficient.

Chairman **Chiles**. When the taxpayer is going to get half of what the value of it is when the sale is made?

Dr. **Miller**. Senator, not everyone understands the fact that the loans that we have outstanding are not always repaid. Some loans are repaid 95 cents on the dollar——

Chairman **Chiles**. But you understand if you sell them under the hammer, you are going to get less money for them though.

Dr. **Miller**. No. The amount of loan paper that we're proposing to sell is very small compared with the total market. As you know, Senator——

Chairman **Chiles**. Do you differ with the chart we put up to show that by 1992 you're losing money off your proposition to sell loans?

Dr. **Miller**. Senator, the President's budget incorporates all the offsetting receipts that would have been coming in by——

Chairman **Chiles**. So you do lose money by 1992?

Dr. **Miller**. No; the President's budget speaks exactly for what we have proposed. And I would say I read the material last night made available to me. I must say I sympathize with you in having gotten it out so quickly after the President's budget was given over to you. But I found the discussion very confusing, and I'm not at all sure that the analysis is correct. And I would like an opportunity to get back to you after we've had time to review that analysis.

[The following was subsequently supplied for the record by OMB:]

LOAN ASSET SALES

It is correct that, while loan asset sales reduce current budget deficits, they increase future deficits. This effect occurs because asset sales move to the present the anticipated future streams of principal and interest payments from the loans.

However, this effect is mitigated by several factors, including the following. First, revenues from asset sales reduce Treasury borrowing and, therefore, lower interest outlays in subsequent years. Second, savings from improved management of credit programs that occur as a consequence of asset sales. Third, the discount at which the loans are sold is actually a measure of the present value of the subsidies implicit in the loans. This loss was incurred when the loans were made; the sale merely makes it explicit.

Dr. **Miller**. But if I could simply summarize again, Mr. Chairman, if you have taxes that continue out into the future, at the time where you have about——

Chairman **Chiles**. But under your own figures in foreign military sales, I think you're showing a loss of $1.2 billion.

Dr. **Miller**. Well, Mr. Chairman, as we both know, the FMS change is not intended to be revenue-neutral.

Chairman **Chiles**. I'll let you finish.

Dr. **Miller**. Yes. But to summarize, in 1992 when we would have a balanced budget, the question becomes would we still have additional revenues? If we did, we'd either have a surplus, or Congress would spend the money. And I believe it's most likely that Congress would spend the money.

Chairman **Chiles**. Or we could say that those revenues had to cease.

NOT A GOOD TIME TO OPEN UP TAX CODE

Dr. **Miller**. Well, you could say they would have to cease, but even in that event, Mr. Chairman, I would argue that there would be a number of things that would happen.

One, I think income tax increases would have a more restraining effect on aggregated economic activity than the kinds of changes that we're proposing. We would put those resources in the private sector where they are more efficient.

To tell you the truth, I just think it would be wholly inappropriate for us to open up the Tax Code so soon after tax reform. I think it would create very substantial problems in terms of aggregate economic activity. I think it would be a big mistake.

So even if you terminated the revenue increase, or the surcharge if you wanted to have a surcharge, in 1992 you would have given up the opportunity to have more efficient government during this time, more efficient allocation of those resources that we propose putting in the private sector, and you would have a larger government than would exist if the President's proposals were carried out.

If I could just finish by showing this. Our proposed revenue changes are 53 percent of the total $42 billion deficit reduction package, and the programmatic changes are $19 billion or 44 percent.

Chairman **Chiles**. We would argue that yours are considerably higher than 53 percent because you have not included your $8 billion increase in defense. So when you net that off your spending changes, your revenue increases are actually close to 100 percent.

Dr. **Miller**. Mr. Chairman, when are you having CBO testify?

Chairman **Chiles**. We will have them probably in the next week or the week after.

Dr. **Miller**. I wish you would withhold your judgment on that until you have CBO to testify. I would be willing to make a side bet with you that they would not conclude that we had underestimated defense outlays by anything like $8 billion.

Programmatic changes: major medical programs are 36 percent, major mandatory programs 18 percent, economic subsidies are 25 percent, and other discretionary programs 21 percent of the total programmatic changes.

On the revenue side, asset sales are 19 percent, government receipts are 28 percent, user fees are 14 percent, privatization is 24 percent, credit reform is 6 percent, and other changes are 9 percent.

Now, Mr. Chairman, I would be glad to respond to any questions.

Chairman **Chiles**. Thank you. Senator Conrad.

Senator **Conrad**. Mr. Chairman, Mr. Miller, as I started to say earlier, we've got a crisis in agriculture, we've got projections; we're going to lose half of our farmers in the next 5 years. In the small towns of my State, it is like a neutron bomb hit. Buildings are still standing, but the people are gone.

SLASHES IN FARM PROGRAMS MISLEADING

In this budget, you have a substantial cut for agriculture and, at the same time, the administration has a strategy of cutting price.

Now, before this budget proposal, the idea was you cut prices to farmers, but you made up for it with government payments. Now you've got the farmer, as I see it, caught between the devil and the deep blue sea because the price cut has occurred, and then you start to cut back substantially on Government support.

I would be interested to know what the thinking is in terms of where this leaves American farmers?

Dr. **Miller**. Senator Conrad, the budget numbers are somewhat misleading in that the reduction from something like $25 billion in farm price supports for fiscal year 1987 to $21 billion for fiscal year 1988 reflect our decision not to pay advanced deficiency payments for the following crop year. They do not show up in 1988; they do show up in the budget for the 1989 column. So that's the major difference that you see in what has been characterized by some in the press as major slashes in farm programs. It's simply the question of when the payments would be made, not whether they would be made.

Beyond that, the proposal that the President has advanced for reforming the agricultural community would save a very small amount from better targeting of subsidies to farmers, and decoupling program benefits from production. Those would save very little in terms of 1988. The major reason is the commitments for 1988 will be made during this year, presumably before the Congress takes final actions on the President's proposal.

Actually, vis-a-vis current services, total outlays for a farm area will increase because the President's proposal for the sugar program, as you know, moving away from the import restraints as we have, does increase total outlays.

So if I could just say, Senator Conrad, I grew up in a Southern State where agriculture was very important. And I do not believe the present system is politically sustainable. There are very large subsidies going to agriculture, and at a time of deficit reduction, I think that people will be looking for less expensive ways of doing it.

LINK BETWEEN SUBSIDY AND PRODUCTION SHOULD BE BROKEN

Senator **Conrad**. What's the strategy then if I might just follow on? What is the strategy to increase price?

Because if you reduce government outlays, I understand you're talking about a timing problem, but if it's timing that benefits the Federal Government, then it's going to adversely affect the farmer.

What is the strategy to recoup on the price side? That is, we've got farmers out there who are failing despite dramatically increased expenditure. We're talking here about a reduction in expenditure, through you argue that it's a timing question. What is the strategy to get farmers more income?

Farmers, believe me, in my State would much prefer to have it come from the marketplace than from the government.

Dr. **Miller**. Right. Senator, what the President proposes is that we break the link between subsidy and production. Today, to get more subsidy, you have to produce more. If you produce more, you put more on the market, that drives market prices down further. It's a system that feeds on itself and it's very inefficient.

We want a system where the farmer gets the subsidy straight out and retires that extra land so that they don't produce more crops on it. And the effect of that will be slowly over time we will be able to have some attrition, as we've had historically in the agricultural community, of the less efficient farmers, and we should be able to solve the problem in four or five years. Nothing draconian is proposed, but I think we need to bite the bullet and do something of a substantial nature.

PRODUCTION RESTRAINT WRONG WAY TO GO

Senator CONRAD. That sends shock waves through the agriculture community when you say that the solution is to have fewer farmers. Unfortunately, that's not going to mean less land under production, and it's hard for many of us to see how that's going to take care of the supply/demand imbalance, unless the administration is willing to sit down at a table with our major partners in the agriculture production and try to work together to have some production restraint, I would hope the administration would.

Dr. MILLER. Let me say, Senator, I think production restraints and cartelizing the U.S. agricultural industry is absolutely the wrong way to go. For one thing, it would have the cost of the farm subsidy program placed on the backs of those people who spend a high proportion of their income on foodstuffs. And I think that's a very regressive tax.

And, secondly, we would have to do something about the question of importation of foodstuffs because, as the domestic price rose, there would be greater imports of agricultural commodities, and for us to blockade that, or to restrict that would cause all sorts of problems in our international treaties with the GATT and with foreign policy generally.

Chairman CHILES. Senator Domenici.

I'm afraid I have to kind of restrain there, Senator.

Senator DOMENICI. Mr. Chairman, I think we ought to go to Senator Nickles, who was here first, and I will ask questions later.

But could I inquire how long does Dr. Miller have to spend with the committee today, have you inquired? Do we know?

Chairman CHILES. I think he has told us that he would try to be with us till close to 2 o'clock.

Dr. MILLER. Mr. Chairman and Senator Domenici, I may have to send out for a candy bar, but I'll be with you.

Senator DOMENICI. Thank you.

RATE OF GROWTH IN SPENDING REDUCED SIGNIFICANTLY

Senator NICKLES. Mr. Chairman, thank you. I just make one general comment in opening. I hope that we can make some real progress in this year in a bipartisan fashion in this committee. Being one that wasn't on the committee, I've seen this committee work together and I've seen it in a very partisan efforts. And really in the last several years, with the exception of last year, we hadn't made much progress.

Now, last year, we did have a significant deficit reduction, and it was about time. $220 billion of deficit, I think, is an embarrassment not only to this administration but to Congress as well, and I think there is plenty of fault to go around.

Now, it looks as if we're making some progress, and certainly a $48 billion reduction from 1985, or last year to 1986 was significant. I went back a couple of years and I looked at spending increases that were 11 percent from 1984 to 1985, spending growth of 11 percent. Then, if I remember right, it was about 5.6 percent for 1986. Last year we're looking at about 2 percent.

If the President's budget figure, the total amount of outlays, is that $1 trillion, 24 billion, the spending increase would be less than 1 percent, That is a significant move in reducing the rate of growth in spending. And again I think we're finally making some progress. And I really hope that that progress will be accelerated and that we can go further.

I'll ask you this, Mr. Miller, and likewise to our chairman and minority leader in this committee, I'm still a little bit troubled on the change in 1987. It was last June. I looked it up in the budget resolution that we passed. It said we were going to have a total deficit figure that everybody is aware of, $144 billion plus possibly $10 billion. I heard the chairman of the committee at that time say we were going to make it. And now I see the estimates say, well, we're not going to be $144 billion, we're not going to be $154 billion, we're going to be $174 billion. Well, that's $30 billion more than the budget resolution that was passed by Congress just 6 months ago. That was only 6 months ago that we said we were going to be $144 billion. Now we're saying it's $174 billion. Mr. Miller, you said that CBO and OMB agreed on that figure.

$20 BILLION ADDED TO DEFICIT

We said that we're going to spend $995 billion, but, now, by your estimates this year, fiscal year 1987, we're going to spend $1 trillion, 15 billion. In other words, $20 billion more than what we said we were going to spend 6 months ago. And every bit of that $20 billion is being added to the deficit.

Now, again, you know, I heard the chairman say that he thought that there was $20 some billion, $27 billion I believe in difference in estimates on what the administration figure would be, and possibly what CBO or some other group would say for 1988. But, heck, we're $30 billion off from what we said we were going to be in the year that we're in, and we've only finished one quarter for the year 1987.

I think it's too early to give up on 1987. I hope that we don't have a $30 billion increase in the deficit for 1987 in spite of the fact that we're making progress. I'm pleased it looks like we're going to make a reduction in the deficit of $48 billion. If we could make that reduction not $48 billion, but if we could make it $68 billion, it would make the chore before us a lot less complicated in the out years.

And just to summarize my question, can you give us the reason why we've seen the increase in the deficit projection since 1987 from $144 billion to $174 billion?

Dr. **Miller**. Senator, I would like to give you a table, a bridge table that would give all the details, and I would submit that for the record if you would like, Mr. Chairman.

Chairman **Chiles**. Certainly. We will include it with your testimony.

[The following was subsequently supplied for the record by OMB:]

1987 BUDGET TOTALS—DECEMBER GRH AND JANUARY BUDGET ESTIMATES

[In billions of dollars]

	Dec GRH	Jan Budget	Change—Dec GRH to Jan budget		
			Admin requests	Ec & Tech Changes	Total Changes
Defense	274.4	282.2	1.7	6.1	7.8
Farm price supports	20.7	25.3	0.0	4.6	4.6
FDIC & FSLIC	1.4	7.8	0.0	6.4	6.4
Other	693.7	700.3	−1.7	8.2	6.5
Total outlays	990.2	1,015.6	([1])	25.4	25.4
Receipts	846.6	842.4	0.1	−4.3	−4.2
Deficit	143.6	173.2	([1])	29.6	29.6

[1] $50 million or less.

DETERIORATION IN ECONOMIC GROWTH CAUSES CREEPING UP OF DEFICIT ESTIMATE

Dr. **Miller**. Let me just say very briefly the estimate that we both CBO and OMB, made were restrained in some respects by the dictates of the Gramm-Rudman-Hollings law. There were some anomalies in the law that were put there for good reason in terms of restraining the parameters on the estimates. For example, we had to make the same assumptions in our estimates in September and October, that we used in the past August. And we might have changed those estimates somewhat in the meantime.

So OMB did estimate at the time that the deficit would be under the $154 billion margin of error under Gramm-Rudman-Hollings, but since then we have had a slight deterioration in economic growth, and that is the main reason we have seen some creeping up in that deficit estimate.

Let me say that when you're talking about a trillion dollars, a difference a $10 billion or even $20 billion as a proportionate matter is not that significant. Keep in mind that estimators do the best they can but they're frequently off by that kind of margin.

Senator **Nickles**. Mr. Chairman, just one final comment.

I might ask the chairman, do you usually operate on 10-minute rule, 5-minute rule or——

Chairman **Chiles**. We are trying to operate on five in this first round so everybody will get a chance.

Senator **Nickles**. I appreciate that. Just one final comment.

Again I think total outlays are most important, and I'm really pleased to see the outlay percentage has decreased and I hope that we'll be successful in keeping it to less than 1-percent growth, 1-percent growth in total outlays.

Chairman Chiles. Senator Fowler.

Senator Fowler. Mr. Chairman, I'm delighted to be with you, and I appreciate your rules.

Director Miller, you said in your response to Mr. Conrad that the farm support payments were not, in your words, politically sustainable, and that the proposals under this budget are "nothing draconian."

I think if you'll remember, that's a change in the tune in just the last 2 months. Prior to November 4, the President himself was bragging throughout the land of the farm subsidies increase in those support payments. And that was a major part of his philosophy.

Now, as I go through the budget this morning and listening to you, I see that there are serious—we'll await the word "draconian" from that—cuts in farm support, nutrition programs, rural electrification, rural housing, rural development insurance, Agricultural Extension Service. Across the board some of the deepest percentage cuts in areas which Mr. Conrad was speaking of, that are the most devastated in our country.

As a fellow Georgian, I am intrigued by your Biblical analogy of government profligacy.

How do you justify those cuts on the Biblical tradition of either justice or mercy?

NO CHANGES PROPOSED IN NUTRITION PROGRAMS

Dr. Miller. Well, I think that they are well justified on both of those criterion.

In the case of nutrition, what we propose is that all those children who are poor continue to receive either free lunches or subsidized lunches. And those lunch programs are very important. I don't think there's any question they're very highly supported by the people throughout America.

What we propose to do——

Senator Fowler. And needed.

Dr. Miller. And used. And they are supported by Ronald Reagan and Jim Miller.

Senator Fowler. And they are needed.

Dr. Miller. Pardon?

Senator Fowler. And they are needed. They are needed. They are a nececssity.

Dr. Miller. They are a necessity. And we propose no changes whatsoever in those programs.

What we do propose is that children of parents whose incomes are above 185 percent, nearly twice the poverty level, no longer receive that explicit subsidy. And we believe that the very minor increase that it would take to cover these expenses are not excessive.

On the question of REA, REA was established during the Great Depression as a means of bringing electricity, and then later telephone service to low density areas, to rural communities. It has done that. Ninety-nine percent of those that anyone would identify as rural, low density areas now have access to electric power and/or telephone.

We propose some cutbacks in what are now very, very low interest loans from the general taxpayer to rural cooperatives. We have nothing against rural cooperatives. We think that the program has succeeded and that the need for these loans that are subsidized by the general taxpayer has ended.

Senator FOWLER. Will you submit——

Dr. MILLER. Rural housing——

CUMULATIVE EFFECT OF CUTS WILL BE HELPFUL

Senator FOWLER. Dr. Miller, if I may interrupt. Will you submit that the cumulative effect of the cuts in the programs of rural America that I have enumerated will be helpful to the situations?

Dr. MILLER. Well, I will be glad to break those out of the budget for you.

With respect to rural housing, what we've proposed to do——

Senator FOWLER. No; I would just like for you to answer my question.

Do you submit that the cumulative effect of the President's proposal for rural America, will be helpful to the situation, helpful to a turnaround in the economy that we now find in rural America, which everyone, including your administration, says is devastated?

Dr. Miller. Senator, I misunderstood you. I thought you asked if I would submit for the record a breakout of these——

Senator FOWLER. Well, I would like those too.

Dr. MILLER. I'll be glad to do that. I'll be glad to answer your question.

I think they will be helpful to the program in the long run.

Senator FOWLER. Well, since my time is about to expire, will you submit in your breakdown the rationale——

Dr. MILLER. Sure.

Senator FOWLER [continuing]. Of why these proposals will be helpful?

Dr. MILLER. I will be glad to do so.

[The following was subsequently supplied for the record by OMB:]

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1/20/87

RURAL PROGRAMS REDUCED IN THE 1988 USDA BUDGET
($ in millions)

Programs	1987 Enacted	1988 Proposed	Rationale
1. Overview			Reduced outlays going to rural America through the Department of Agriculture (USDA) will not be harmful because: - each of the changes is individually justified based on need or efficiency (see below). - on a per capita basis, more Federal aid still goes to rural areas than to urban. - overall growth in the total economy, along with reduction in the deficit and in tax rates, is much more helpful to rural America than stop-gap and outdated Federal direct assistance measures.
2. Farmers Home Administration			
Rural Development Loans and Grants - Loan and grant obligations	650	-0-	The budget proposes to terminate rural development loans and grants because this is purely a State and local responsibility. In addition, private credit markets are readily available for funding local infrastructure development projects such as water and sewer facilities.

Programs		1987 Enacted	1988 Proposed ($ in millions)	Rationale
Rural Housing Loans and Grants				
- Units Assisted:	USDA	53,730	21,200	The 1988 budget will assist more very low income rural persons than would current programs. The budget would replace the costly rural housing loan programs with a more flexible housing voucher program similar to that administered by HUD. Vouchers will: (1) permit tenants to choose where they live; (2) encourage use of existing housing stock rather than promote unneeded new construction; and (3) channel assistance directly to users rather than through middlemen (such as construction syndicates used for tax shelters).
	HUD	15,800-19,800	15,800-19,800	
	Total	69,530-73,530	37,000-41,000	
Agriculture Credit				
- Loan obligations		4,315	3,795	Operating credit is provided at the full levels authorized by the Food Security Act of 1985. The major difference is in new loans for farm ownership on grounds that this is not the time to help new marginal borrowers enter farming. The 1988 budget provides for continued expansion in the guaranteed lending program. Program levels for guaranteed farm loans will increase from $1.4B in 1986 to $2.2B in 1987 to $2.5B in 1988. Direct loans for operating and emergency purposes total $1,295M for FY88. No new federal funds will be provided for more farm ownership loans. However, existing borrowers will continue to receive FmHA assistance under its liberal forebearance policies which include loan deferrals, rescheduling and subordination. Last year, FmHA extended repayment terms for 120,000 of its loans while subordinating its lien on 30,000 loans.

Programs	1987 Enacted	1988 Proposed	Rationale
	($ in millions)		
3. Conservation Programs - Outlays	977	2,023	Outlays more than double from 1987 to 1988. Provides substantial funding ($1.4 billion) for implementation of th Conservation Reserve Program authorized in the 1985 Farm Bill. Funding is provided to terminate outdated conservation cost-sharing and watershed financial assistance programs. Funding is continued for soil and snow surveys, plant materials centers, and technical assistance necessary to implement the Conservation Reserve Program.
4. Extension Programs - Outlays	332	263	Terminates categorical grants to States for such programs as lawn and garden care, and food and nutrition education. These programs are long-standing basic missions of the State extension service and can be carried out under the formula grant program that is fully funded in this budget, if supported as priority activities at State and local levels.

Programs	1987 Enacted	1988 Proposed ($ in millions)	Rationale
5. Rural Electrification Administration Loans			
- Loan obligations			Reduced loan levels for REA will not threaten rural cooperatives. REA has already met its purpose of helping to provide electricity and telephone service to rural areas. REA was started in 1935 when only 12% of rural areas had electricity. Now 99% have electricity. Large Federal subsidies are no longer needed. Beginning in 1988 or earlier, if Congress enacts the required legislation, a new guarantee program will be established to ensure that rural cooperatives obtain adequate financing to continue servicing rural areas. Under this program, REA will guarantee 70% of the principal amount raised in private markets. The only borrowers who will not be eligible for this new program are companies that: (1) primarily serve urban, suburban, or recreational areas, or (2) are members of large corporate holding companies. The exclusion of these borrowers will not affect rural service and will save taxpayers millions of dollars.
- Direct (including FFB)	1,971	383	
- Guarantees (private)	0	840	
6. Federal Crop Insurance			
- Outlays	637	482	Federal Crop Insurance subsidies will be phased out over 5 years. In this time, Federal subsidies will be gradually ended and premiums will be increased to an actuarially sound level.

Programs	1987 Enacted	1988 Proposed ($ in millions)	Rationale
7. Meat and Poultry User Fees - Outlays	373	0	User fees for meat and poultry inspection will not harm rural communities. The companies who receive these services are fully capable of integrating user fees into their cost structure, especially since these fees will represent only a small fraction of total revenues. Eventually, even if all of the burden falls on the general consumer, the increase due to user fees would be no more than about 1/3 cent per pound of meat. The implementation of user fees will increase efficiency and reduce the deficit, it will not jeopardize the safety of food supplies or harm the farm community.
8. Price Supports	25.3	21.3	Differences between the 1987 enacted level and the 1988 President's budget are due to advance deficiency payments that were shifted forward into FY 1987 from FY 1988. Thus, farmers will receive part of their 1988 payments early, increasing the present value of the receipts to them. In the long run, the Administration's farm reform proposals will reduce costs to the taxpayer; provide greater competitiveness in world markets; eliminate unnecessary and unacceptably high producer payments but still give the family size farmer the income protection he needs. In addition, the Administration will seek reforms in the domestic sugar program. The sugar program costs consumers about $2B a year and runs counter to the Government's international objectives. Total economic costs will be reduced by the reform proposal although near-term Federal costs will be higher.

Other agencies

Programs	1987 Enacted ($ in millions)	1988 Proposed	Rationale
9. Economic Development Administration (EDA) - Outlays	222	163	EDA provides public works grants to States and communities, and loan guarantees to businesses. Because the grant progam interferes in the decision-making process of States and local governments by approving local projects at the Federal level, and the loan guarantee program distorts private financial markets by funding projects that would not merit resources under other criteria, the Administration proposes to terminate the EDA and rescind the unobligated portion of the 1987 congressional appropriation. About 70 percent of EDA's grant funds in 1986 were targetted to rural communities.
10. Appalachian Regional Commission (ARC) - Outlays	146	122	ARC administers highway and economic development programs. The Administration proposes termination of the highway program to eliminate the redundancy created by the overlap between ARC and the Department of Transportation's Federal Highway program. Development funds are terminated because Appalachia's crisis is part of a national crisis, the solution of which will not be found in a regional approach.

Dr. **Miller**. You see, Senator, the most important thing we can do for rural America and for non-rural America is make the economy grow and make the economy expand. If resources were free, we would not be here making these kinds of decisions. But I think we have to realize that tradeoffs must be made in order for the deficit to come down, for spending to be kept inbounds, and for the economy to expand.

Senator **Fowler**. My time has expired. Thank you, Mr. Chairman.

Chairman **Chiles**. Senator Grassley.

SUPPLEMENTALS ARE BUDGET-NEUTRAL

Senator **Grassley**. Dr. Miller, the administration is going to send up a supplemental appropriation bill. The situation, as described by Senator Nickles, is exactly on target, and not only on target for this year, but that situation could be similar for each of the last 6 years.

Why doesn't the administration start correcting the situation as Senator Nickles has pointed out by not even sending up a supplemental appropriation bill and a request for additional money?

Dr. **Miller**. Well, Congress mandated a 3-percent increase for all Federal employees, but did not appropriate the money, so we have to come up with some of that money in the form of a supplemental. That's the reason for the pay supplemental.

Secondly, we have a supplemental of about $1.3 billion in budget authority for the international accounts. The President believes and Secretary Shultz believes that the cuts made by Congress in some of those areas were truly draconian; that for purposes of embassy security and for meeting some of the needs of countries that we have made substantial commitments to, we need those additional funds.

In the case of defense, the President believes also the, failure of Congress to appropriate monies consistent with the Congressional Budget Resolution was a substantial oversight, and he proposes that additional monies in the neighborhood of $2.8 billion in budget authority be appropriated to the Defense Department for a variety of program activities.

We have provided offsets for these so that the net impact on the budget would be zero. We have proposed a whole package of rescissions and deferrals that would have the effect of making these supplementals budget-neutral.

Senator **Grassley**. What you are going to end up is a situation where Congress is going to accept the rescissions and they are going to accept your suggestions for increased expenditures, at least to some extent, probably add considerable to it, and we are going to have a worsening consideration than we anticipated.

The situation is different now in January than it was as we anticipated in September when we passed the continuing resolution, and we can take those, and I would urge the Administration to take those changing situations into consideration. And it is pretty much as Senator Nickles has laid out.

POSITIVE SIGNAL BEING SENT ON PAY INCREASES

Let me ask, too, what sort of a signal does this send to the country at large whether or not the administration is serious about the budget when we suggest massive salary increases for administrators, Cabinet members and Members of Congress? And that comes from the President who quite regularly points out the fiscal irresponsibility of Congress.

Dr. **Miller**. Well, Senator, the President received the report of the Quadrennial Pay Commission, which was established by Congress. And this Quad Commission identified a substantial shortfall between the salaries of Congressmen and Senators, judges, and senior officials in the executive branch and what they would be earning in the private sector.

Senator **Grassley**. I understand the rationale. What sort of a signal does it send?

Dr. **Miller**. The Commission recommended that the President propose to Congress a salary of $135,000 for Congressmen and Senators. He did not do that. He cut that recommendation way back, while recognizing the principle of comparability. He said in his budget message that at a time of deficit reduction and stringent budgets, it did not make sense to do this all in one fell swoop and, therefore, he has proposed an increase of congressional salaries from $77,400 that exists today to $89,500, approximately a 15-percent increase. He believes this goes toward the goal of comparability, recognizing the budget stringency that we have today.

The total cost of this increase that he has proposed is less than $40 million, even though it covers a large number of people, $40 million for fiscal year 1987, a little bit more for fiscal year 1988 and thereafter. But while that is a substantial sum as compared to the overall size of the budget, it is not that large of an amount.

Senator **Grassley**. The administration believes then that it is not sending a negative signal about how serious Congress is about a budget deficit.

Dr. **Miller**. No, Senator. I think the President is sending a positive signal in recognizing that a pay increase on comparability grounds of substantial magnitude is warranted but that he will not propose to Congress that they accept a proposal raising congressional pay by anything like the amount that was recommended. And by the way, the recommendations of this Quadrennial Commission are very consistent with recommendations of prior Quadrennial Commissions appointed during Democratic as well as Republican administrations.

STRUCTURAL DEFICIT CLOSE TO $200 BILLION

Chairman **Chiles**. I call on Senator Sanford next. I just point out to Senator Nickles that if he is concerned about the increase of $174 billion, and I think that is a legitimate concern, he probably won't feel very well when he learns that $23 billion of that is 1 year's savings. It's the first time our reconciliation will get less savings in year two and year three than in the first year because of these one-shot savings of asset sales. So if you really want to look at what we have done to the structural deficit, you almost have to add $23 billion more. When we pat ourselves on the back and say we have come down to $174 billion, that actually may be closer to $200 billion as far as a structural deficit because of the dependence on 1-year saving.

Senator Sanford.

Senator **Sanford**. Thank you, Mr. Chairman. I would certainly reiterate the thoughts that Senator Conrad and Senator Fowler expressed about rural America and farm economy. And I wish to underscore and associate myself with the concerns they have expressed, and we will have more opportunity to discuss that.

Then I have a number of questions about support of education, but I think there is a better time in these hearings to discuss that so I will wait for that time.

SPENDING REDUCTIONS AND REVENUE INCREASES ARE RIGHT MIXTURE

I would just like to ask a couple of fairly simple questions. I probably would have asked this question 6 years ago if I had been here, and every year since; that is, doesn't the President feel any compulsion to present a balanced budget?

Dr. **Miller**. Senator, I think the President has expressed to me great consternation over this deficit situation and, frankly, great consternation over the notion that some would accuse him of contributing to the deficit.

On a number of occasions, the President had engaged in some deals with Congress which he feels Congress didn't carry out. The tax increase of 1982 is one in which the President feels that what he was promised was never delivered. He does lament the fact that we had a recession in 1982, which resulted in about two-thirds of the deficit that we have experienced being attributed to the lower revenue line because of the setback with the recession.

A little over a year ago, the President and the Congress came together and agreed on a deficit reduction time path to get to a balanced budget, and last year and this year the President has submitted budgets that meet the Gramm-Rudman-Hollings deficit targets. Our requirement is not to meet the deficit reduction targets as computed by just anyone but computed by ourselves.

Now, I realize that some people would make different estimates. Some people believe that our estimate of the current services deficit is way too high. Some others believe it is too low. As I indicated, Senator Chiles, the paper I have indicates that CBO has come in with a preliminary estimate the fiscal year 1988 current services deficit $169.2 billion, which is $19 billion over ours.

Senator **Sanford**. Well, yes, but that doesn't really answer the question, because I think that presidential leadership requires a sense of fiscal responsibility and I don't think we have seen it. That is my basic question, which I assume can't be answered.

Dr. **Miller**. It is more of an allegation than question.

I would say the President believes, and I think he is correct in this, that any step you took today to eliminate the budget deficit entirely would cause more problems than allowing the deficit to be at the $108 billion level. I mean you could raise taxes of sufficient severity to close that gap completely, or you could cut spending a sufficient amount to reduce the deficit to $108 billion, or some combination. But he does believe that the combination that we have now of spending reductions and revenue increases that brings us down to the $108 billion figure is about the right mix and it observes the Gramm-Rudman——

Senator SANFORD. Granted, but had this been the first year the President had submitted a budget that wasn't in balance, that would be a good answer. But it has been that way for 6 years.

APPLY SALE OF ASSETS TO NATIONAL DEBT

Let me ask you another question, that is, selling off the assets of the American Government.

Normally, in business we do not perceive it as a good business practice to spend assets to meet current expenditures. I suppose there are those of us who have come to the Senate who have set aside assets that we will have to sell off to live. But that is not a good practice. And nobody ever talks about the national debt. I am not quite sure why.

But wouldn't it form a certain wholesome discipline if in selling off our assets, instead of applying that to current expenditures, that we apply it instead to the national debt?

Dr. MILLER. Well, Senator, you have a very interesting proposition, and I would want to think about it a bit. I think at the present moment, until we get the deficit down to zero in 1991, we need to use these loan asset sales for that purpose.

But I think you have hit on a very good idea that at least we ought to give serious consideration to, and that is, when we do have opportunities for asset sales, perhaps applying those funds to the retirement of the debt in the out year.

Senator SANFORD. I think the discipline of that would be very worthwhile.

Let me ask one other question.

Chairman CHILES. I am afraid we have to——

Senator SANFORD. Well, I am really satisfied. I did not especially want to ask that question anyhow.

Chairman CHILES. Senator Kassebaum.

Senator KASSEBAUM. Thank you, Mr. Chairman.

INCREASE IN FAA FUNDING PROPOSED

Dr. Miller, I would like to ask first about the aviation portion of your recommendation on the budget. In the 1987 fiscal year, about 30 percent of the FAA operations came from the aviation trust fund. You are recommending now that approximately 75 percent come from the trust fund.

Over the years, we have quarreled that we do not spend out the trust fund at the levels that we have agreed to. On the other hand, with this recommendation, of course, it is a significant use of the trust fund rather than the general revenue moneys, which will mean that facilities and equipment and other aspects of airport development could well suffer losses if it will be targeted as you propose to target it. And I can certainly understand why you wanted to use the trust fund rather than general revenue moneys, but it will put us in a bind with other aspects of the trust fund.

How do you rationalize that?

Dr. MILLER. Well, Senator, what we are proposing, again, is a 20-percent increase in total FAA funding and also a 68-percent increase in the funds going for modernization of the air traffic control system.

In terms of financing more of the FAA's operations out of the trust fund, the trust fund is, of course, comprised of moneys that air passengers pay, the 8-percent tax, and also moneys that are paid by the owners of aircraft and other revenues.

We believe that just following the basic premise of those who benefit ought to be those that pay it is appropriate to pay a greater share of the FAA's total costs out of the ticket tax and other user charges rather than have these costs paid by the taxpayers in general. And as you know, there have been balances that have been building up in that trust fund.

Senator KASSEBAUM. Well, that is true. It is not because we have not been wanting them to be spent for the things they should be spent for, as a matter of fact, out of the trust fund. And I would argue that because, actually, by this shift, you are reducing by $2 billion FAA money from the general revenue funding.

And I suppose it is the old argument, does the public as a whole benefit from a sound and safe national aviation system or just the users of the system? I think there can be an argument that the public as a whole benefits.

Dr. MILLER. Right. But this is really a mix. I guess what we are talking about is really the mix between how much is supported by general revenue and how much is supported by this targeting.

Senator KASSEBAUM. Well, that is true. It is just when we passed the ADAP legislation on which we set the levels of the trust fund, which will be reauthorized this year, we agreed to certain percentage of levels that went to operation management and facilities equipment and so forth. And as much as I want to see more money go into the improvement of the aviation system, I feel that this large a jump—larger than any other budget recommendation in 6 years out of the trust fund—will do some harm to the trust fund system.

NONRECOURSE LOANS NOT INCLUDED IN $50,000 CAP

I would like to ask a question on farming as well, not to get into the concerns of the rural economy. You mention limiting to $50,000, instead of $250,000, the cap on payments Does this include all loans in the $50,000 eligibility?

Dr. MILLER. Yes; oh, excuse me, not nonrecourse loans.

Senator KASSEBAUM. Not nonrecourse loans.

And you have said loopholes will be closed. Have you worked out any system of how, indeed, loopholes will be closed?

Dr. MILLER. We have some regulatory discretion on that, but I think we need legislation in that it is not easy. Senator, you probably know this a lot better than I do. But stopping the ability to divide farms up and divide ownership of family farms up, to get around the ceiling on the payments is not easy to do. We look forward to working with members of Congress, and we would rather fashion legislation to do this.

Senator **Kassebaum**. Well, I think all of us have some concerns about the present farm program, but nevertheless, the rural economy of America is undergoing some devastating changes.

FARM BILL ESTIMATED AT $76 BILLION

Dr. **Miller**. Could I just say, Senator, and again, in responding to Senator Fowler, I really feel that we need to preserve the values on the family farm. And what the President is proposing is a system that we can do that, but not run the risk of a reaction against it.

Here is a program that was $4 billion in 1981 that has risen to $25 billion. Last year, just over a year ago when the President signed the farm bill, our estimates of the cost of the farm bill were $51 or $52 billion over 3 years. Our latest estimate is $76 billion. So a 50-percent increase in just 1 year.

I am just very concerned that we do something about the basic problems in a much more efficient way. That is our purpose, not in any way to turn our backs on the hardship in rural areas.

Senator **Kassebaum**. Thank you. I've run out of time.

Chairman **Chiles**. Senator Sasser.

PRESIDENT SHOULD SUBMIT BALANCED BUDGET

Senator **Sasser**. Thank you, Mr. Chairman.

I was struck by the statement made by our distinguished colleague and friend from North Carolina, Senator Sanford. He simply asked the question, well, why does the President not submit a balanced budget? That is a good question and one that I think deserves to be answered.

Sometimes I think we sit here on this Budget Committee and overlook what ought to be the obvious. But I think the President's budget that has been submitted, Dr. Miller, does say a few things that are worthwhile. One, I think it does meet the requirements of the Gramm-Rudman-Hollings Act, or I suppose now we are calling it the Hollings-Rudman-Gramm Act, Mr. Chairman. And I think it does fulfill the President's obligation to submit a fiscal blueprint to Congress. It does that. It gives us a starting point. And I think probably more importantly, it outlines what the President's policy priorities are. That is important for the Congress to know and important for the American people to know.

PRESIDENT'S BUDGET RAISES NEW REVENUES

This budget does something else this time, something that I think we ought to note very, very carefully. It rejects the notion that deficit reduction can come on the spending side alone. Included in this President's budget are some $22.4 billion in additional revenues, and they come in various and sundry ways. Over $4 billion of it comes, as our distinguished Senator from North Carolina pointed out, in the sale of government assets. But $6 billion of it comes in the form of additional revenues.

It ranges, as Dr. Miller has indicated, from $2.4 billion in additional revenues that come by way of increased funding for the IRS, which means the IRS is going to be more efficient in collecting taxes.

Dr. **Miller**. That are owed.

Senator SASSER. So that is going to be more taxes.

It comes in the form of increased fees imposed by the Nuclear Regulatory Commission. It comes in the form of inspection fees for the Immigration Service. We are even going to get in the business of selling fishing licenses here at the national level because we are initiating a federal marine fishing license fee for commercial and recreational fishing. Looking at the fine print, we are even increasing the contributions of the District of Columbia and its employees to the Civil Service Retirement System.

So I think this budget, Mr. Chairman, is a significant departure from previous budgets because we are seeing, I think, an acknowledgment here in this budget that we are not going to be able to do it all by making cuts on the spending side.

ATTACK STRUCTURAL DEFICIT

Now, Dr. Miller, that may be a start, but we have got to commit ourselves to remedying the structural deficit implicit in the budgets that are presented by this administration.

In my 10 years on this Senate Budget Committee, I have seen the structural deficits that are submitted by various administrations grow by 300 percent. So it comes back to Senator Sanford's question, and one that probably ought to come from a governor, a former governor of a state who had to balance his budget, and a former president of a great university who had to give some thought to balancing the institution's budget as well.

Why does the administration not submit a budget to this Congress that makes significant inroads in reducing the structural deficit, and get us on the road to a balanced budget? That is a fundamental question.

Dr. MILLER. Senator, maybe I should just turn the question. I would try to emphasize the point that there are no easy answers by maybe asking you if you have any advice to the President as to how he would submit a balanced budget. There would be the possibility of eliminating spending of that amount or increasing taxes of that amount, and I do not think there is any easy answer.

I think the present progress toward a deficit, a zero deficit by 1991 is the preferred course of action. Maybe you would disagree. Do you have any——

Senator SASSER. No, I do not disagree, Dr. Miller. The President proposes and the Congress disposes, and this President is proposing once again a budget which has very large structural deficits. We know there are no easy answers. You and I both know that. But at some point, we have to face up to these tough problems and try to deal with them, and we need to face up to this structural deficit.

We have a saying down my way that at some point you have to belly up to the buzz saw, and we have not done that for the past 6 years.

Dr. MILLER. I would not want to do that. Mine is too large. [Laughter.]

Senator SASSER. I think we are now reaping the whirlwind from it, and we are going to continue to do so. I could go on, Mr. Chairman, but I see my time has elapsed.

Chairman CHILES. Thank you.

Senator Quayle.

Senator DOMENICI. Let me first just say you have done very well without the buzz saw. You lost a lot of weight.

Dr. MILLER. Thank you, sir.

Senator QUAYLE. You did not even have to get up there to the buzz saw, did you?

Dr. MILLER. No; I was afraid of that buzz saw.

Senator QUAYLE. I might say, after these holidays, Dr. Miller, some of us might want to belly up to that buzz saw.

Mr. Chairman, congratulations to you on your selection and your ascendancy to the Chair of the Budget Committee. You do have a tough act to follow, but I know that between the two of you in cooperation as it may be parceled out on both sides, we look forward to a very good stewardship under your leadership.

PRESIDENT TO GET MOST OF BUDGET REQUESTS

Dr. Miller, there has been a lot of discussion and statements that we need to have cooperation between Congress and the administration. We have to change the spending mix. Everybody knows that there will be some changes in the budget; that is nothing new.

I guess the spirit of how far the cooperation can really go depends on how we define cooperation. If we are going to define cooperation as radical cuts in defense, increase nondefense and raise taxes, that approach, as we all know, will simply go nowhere.

I think a lot of people feel that they are going to reduce this deficit by exchanging defense spending for nondefense spending are going to find a little different scenario this year; there is not that much in the defense——

Dr. MILLER. That is right.

Senator QUAYLE [continuing]. That they are going to be able to take out. The numbers are not there. Just for procurement alone, you have to be basically at a frozen level of what was spent last year. And everybody says, procurement is where the big dollars are. Well, it is about a third of the defense budget.

When people start digging into the defense account this year, they will find a lot less, unless they are willing to go beyond that of which I believe even some of the critics of this defense buildup—I am a supporter—would be willing to go in the past years. There is just not that much left in defense.

Therefore, I believe within the spirit of cooperation, there are going to be changes, and adjustments, but I do not think we are going to see dramatic or radical changes that some have suggested. I would say that when the final count is taken, probably 80 to 90 percent of what the administration has suggested will finally be accepted in one way or another. I do not know whether it will be by veto, whether it will be through cooperation, whether it will be through bipartisanship or whatnot. But we still have the Republicans in power of the executive branch, while the Democrats are in power of the legislative branch, so there has got to be some give and take on both sides. We recognize that and we look forward to that opportunity.

BUDGET REFORM

When we get into these budget binds, which we have been in year after year—at least the 6 years that I have been in the Senate—it is always nice to start to talk about reform and change of the budget process. I noted an esteemed columnist in the Washington Post this morning, David Broder, had a rather complimentary article on Dr. Alice Rivlin who has been before this committee a number of times and is respected on both sides of the aisle. She made a rather major address to the Association of Economists on some of the budget reforms that ought to take place. One of her top priorities was a 2-year budget which many on this committee support.

There are other things that she mentioned. As a matter of fact, she went on to talk about even reorganization of the committee structure here in the Congress, which I have also talked about. She talked about reorganization. As a matter of fact, she was going to take OMB and put it in Treasury, but that is not what we are here to talk about today.

Dr. MILLER. I imagine she went too far.

Senator QUAYLE. She went too far on that. But it was a thoughtful column. I haven't read her article, but I intend to. As we talk about budget process and do not really want to get down to the tough decisions, we like to look at some changes of the process. And quite frankly, I think from time to time it is good to change the process. I believe a 2-year budget would be fine.

RESCISSION REFORM

One of the things that I have been particularly interested in, and my chief co-sponsor on this measure, is another Budget Committee member; he has moved up, as Senator Domenici pointed out, from being way down there at the end where Senator Conrad is to way up there to number three or four; and that is Senator Exon. We proposed increased rescission authority through trying to change the rules and the procedure on how we deal with rescissions.

Over the last couple of years, the administration has sent up several hundred rescission measures, yet for all practical purposes, they have been discarded. Only a few million dollars worth has been acted upon from something like $12 billion worth of rescission.

We have not even had the idea whether we ought to be for it or against the rescissions. Under this legislation, which is in the line of trying to get a reduction of spending, we have suggested that we change the rescission process by providing that when you want to rescind something—the measure must by voted on. One of the criticisms I ran into on the floor last year is that there were too many rescission measures that they could possibly be sent up, so we are saying send up one rescission measure per agency, but once you send it up, Congress is going to have to vote on it.

Either House may kill a rescission by a 51-percent vote. If the Senate says 51 percent said no, we disagree with that, or 51-percent of the House disagrees with that. But if both the Houses say yes, we agree with that, 51-percent each, then the President can sign it—which I presume that he would since he recommended it—treat it like a piece of legislation. I think this might help out in a small way to begin to reduce the budget deficit.

Now, I am one that guards the prerogatives and the responsibilities and the authority and the constitutionally defined aspects of Congress very closely and very jealously, as we all do. I do not believe this proposal is giving anything up in that regard. I wonder if you might comment on the idea of changing the rescission authority and how that would be accepted or not? Do you think it might help in some small or major way in getting some more budget deficit reduction through process rather than through specific recommendations in the budget?

FAVORS RESCISSION REFORM

Dr. **Miller**. Senator, as you will remember, when we first talked about this, I was not all that warm on the idea. I had to think it through, and especially I was caught up with the notion of the line item veto, which let me just state for the record the President still supports and I do, too.

But the more I thought about it and the more I recognized the reluctance of Congress to grant the President the line item veto, the more intrigued I have become with your proposal.

It is very much like a line item veto with the following exception: The line item veto would mean that two-thirds of both Houses would have to say no to the President to prevent the President from marking through something. In your proposal, only 51 percent of one House would have to say no.

And, goodness, that would hardly constitute much of a transfer of power to the President. I think it would be respectful of the constitutional perogatives of the Congress in these areas.

So let me say I have personally come around to the view that this makes a lot of sense. Surely, there are things that would be picked out of appropriations measures that I do not think could begin to stand the test of an up or down vote in the Congress.

I think for that reason it would begin the process of moving toward more carefully weighing these individual initiatives that are put in appropriations measures, and giving the President—whether the President is a Republican or a Democrat—the chance to go through and identify pieces of appropriated matters that do not respond to the needs of the general public.

So I have come to the conclusion that you are right.

Senator **Quayle**. Good.

Chairman **Chiles**. Senator Exon.

Senator **Exon**. Mr. Chairman, thank you very much.

Dr. Miller, thanks for coming here this morning. Clarify for me, if you can, because I want to know where I am placed in your mind before I go into the question.

Dr. **Miller**. Very highly, sir. Right at the top line.

BUDGET DEMAGOGUERY

Senator **Exon**. Thank you. Then you will not mind answering my question. When you introduced the President's budget at a press conference, you made some reference—and I saw you on television—that this might be demagogued or some such phrase. What did you mean by that?

Dr. MILLER. What I meant is there are times—and I realize the Congress is a collection of 435 in the House and 100 in the Senate, and one person does not represent the whole Congress. But I just have a concern that the President's budget in the past year or so has not received, I think, the respectful analysis and evaluation that it deserves. There have been people in Congress, associated with Congress, sometimes on the record, sometimes off the record, who have engaged in, I thought, extraordinarily unfair, uninformed criticisms of the President's budget.

The reason I said that is that I hope that members of Congress will read the President's budget. Obviously, members of Congress are going to have various ideas about the President's budget. The question was asked of me if the President's budget would be adopted by acclamation, and the answer is clearly no. Congress carries out its responsibilities to make whatever changes they think appropriate.

Senator EXON. Along that line, then, since neither of us consider each other demagogues——

Dr. MILLER. No, no. Let the record show.

DOES PRESIDENT'S BUDGET MEET G-R-H

Senator EXON. Let me ask the follow-up question. Are you testifying this morning that the President's budget document that you prepared and that you made the presentation of here this morning honestly and forthrightly meets the Gramm-Rudman targets? In my view, it is very far off. My friend from Florida, Senator Chiles, among others, said you are $27 billion off on the deficit just to start with.

Are you testifying that you honestly believe that if we adopted this budget in toto, we would meet Gramm-Rudman targets?

Dr. MILLER. Yes; to the best of my knowledge and belief.

Senator EXON. We had about the same testimony from your predecessor, a man by the name of David Stockman, on numerous occasions when I sat down on that end of the table 'He had just not read the tea leaves correctly. Is that a fair assumption?

Dr. MILLER. I really would not want to comment on that, sir.

BUDGET NOT REALISTIC

Senator EXON. In my view, this budget is not a realistic one. I do not think it is an honest one. I do not mean that you are dishonest.

Dr. MILLER. Thank you.

Senator EXON. But I think that you have taken some assumptions that are way, way off base 'I hope you are right. I hope we come out somewhere near this, but I think it is so far off base there is no chance.

Let me get to a——

Dr. MILLER. Senator, could I just raise this? You know, the difference in our assumptions with CBO are not all that great, and I think the major difference that we see in the revenues are on those growth assumptions. But we really have not had time to work with CBO to figure out the precise differences, and they have their estimating procedure, which we call euphemistically a black box. So we really do not know all the sources of the differences yet.

Senator EXON. Does the OMB budget meet Gramm-Rudman targets in the out years?

Dr. MILLER. As the chart showed [1], and as I will give you, Senator, in a document, it does not meet the Gramm-Rudman targets in the out years. We do not interpret the Gramm-Rudman-Hollings law as saying that the budget submitted has to meet it in each subsequent year, only in the year in question.

Senator EXON. So even your budget does not meet Gramm-Rudman targets in the out years?

FOREIGN GOVERNMENTS FAVORED

Dr. MILLER. It does not meet Gramm-Rudman targets in the out year. They are about $20 billiuon over in each year in the out years.

Senator EXON. All right. Let me go into this. Each and every year, the administration has come forth with what I consider an attack on the REA programs in rural America. I assume you are continuing that this year.

I did notice, however, though, that you have pirated one of the ideas that have come out of Congress and used it in another area. For many years, the Congress has attempted to allow the REAs to prepay their existing loans to take advantage of lower interest rates. The administration has always opposed that.

Do you still oppose it?

Dr. MILLER. Well, Senator, we fought that battle and we lost. What we are proposing here is that REA organizations that want to prepay loans do it with the agreement that they will not borrow again from REA.

Senator EXON. Well, I do not think that is likely. At any interest rate?

Dr. MILLER. No.

Senator EXON. Well, just let me say that I thought it was rather interesting. After following that procedure with REA, which you still obviously would like to do if you could, you yourself in this budget have taken the same benefit that we in Congress wanted to give to the REA, and you have now proposed that we give that same benefit to foreign governments with arms assistance loans.

Do you think it is consistent for the administration to agree to give the same benefit to foreign governments on arms sales that you thought it was not prudent to give to the REAs? Is there not some degree of inconsistency when you propose a program that would help foreigners but not citizens of the United States?

Dr. MILLER. Senator, I think I would be blind if I would not indicate to you that I thought that there was some apparent inconsistency. The President does propose, however, that foreign governments be allowed to trade in their loans in exchange for a balloon payment at the end.

We think that there is an ongoing relationship between the U.S. and these foreign governments with respect to their own defense and the defense of the free world that they contribute. But in the situation of REA, which is a commercial activity that is really fully matured, if the loans are to be traded in, that additional debt should come from the private commercial markets.

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[1] See p. 14.

Chairman CHILES. Senator Rudman.

Senator RUDMAN. Well, thank you very much, Mr. Chairman. Let me tell you that I am delighted to be on this Committee. After having served in the Appropriations Committee for 6 years and hearing of all the shackles that this very powerful Committee was placing on the appropriators, I decided I would love to have the opportunity to help fashion the shackles. So I am delighted to join you here.

Chairman CHILES. We are glad you are here, and we hope you brought your shackles with you.

DEFICIT THRUST DOWNWARD

Senator RUDMAN. I did. I did. I also must say that after listening to this discussion this morning I think that one thing certainly can be said: that is, due to the work of the Budget Committee, and in particular, the chairman and the ranking member working together last year, we did in fact, for the first time in 6 years—on a congressional initiative, not an executive branch initiative—switch the direction of budget growth. And, whether we are going to miss the target by $10 billion, $20 billion, or $30 billion, to me is important, but not key.

What is key is that we have a plain that is downward. We probably will miss the target this year, we will probably miss it the year after. I think that is saying to a football team who is favored by 60 points, you only won by 40, so you are bums. It makes no sense at all. The structural deficit is still a problem, but we are finally heading downward, and that is truly what is important. I have always believed that Gramm-Rudman-Hollings was truly not a mechanism but a mentality. I think we have the mentality here to start shrinking the deficit.

WHAT IF PRESIDENT'S CUTS NOT MET?

Director Miller, I just have one question for you, and I would love to get an answer. I do not think I will, but I am going to ask it anyway, because this question is going to be answered at some point in the next 4 or 5 months. We will eventually reach a compromise.

I have looked over the summary of the budget. You have as much as $28 billion in proposals that we have previously had before us and have rejected. I am in a good position to ask this question because I have been part of a minority which has supported some of those proposals on a number of occasions. Previously rejected proposals include such things as termination of Legal Services, an increase in guaranteed Student Loan origination fees, eliminating EDA, the Amtrak proposals, the REA subsidy proposals, Medicaid caps for the States, reductions in Child Nutrition Programs, and changes in Federal Retiree Employment Programs.

Those, together, by my calculations, amount to about $28 billion. It is my view, politically, that you are not going to get those program cuts. I am not being disrespectful to the President's budget. I am from New England. We try to do things concisely up there. We compress things if we can. That is our nature.

So rather than talk about this for a long time, let me say that I do not think you are going to get that $28 billion. If you lose that $28 billion you are in big trouble. You are then significantly over the target. You may do what a lot of people around here are afraid will be done; you say fine, we will take the $10 or $12 billion dollars from defense growth. We will freeze that at this year is level and. we will be even worse off than we are now. That is not acceptable.

What is your proposal going to be for that $28 billion? Or let's say you are going to get half of it. Let's say we are going to be lucky this year. Let's say you are going to get $14 billion of it.

Now you are $14 billion off. What do we do then?

Dr. MILLER. Senator, at that time, if that were to materialize, I would be more than happy to sit down and work on the shortfall. I think it important that we talk seriously about these individual initiatives the President has proposed.

Let me say, Senator, I think the prospects for our working together, Republicans and Democrats on the committee, and with the President, and others in the administration, are better this year perhaps. We do not have the arrival of a campaign. I think we can be a little more leisurely and a little more philosophical perhaps, and a little more introspective on these issues.

So, I am hopeful that we will be able to come around to reaching an accord on these issues in the next several months, but at this point, Senator, I regretfully decline to suggest just how——

Senator RUDMAN. Well, that is the answer that I——

Dr. MILLER [continuing]. I would make up a shortfall of that magnitude.

Senator RUDMAN. That is the answer I expected, and I think that giving your position, it is the one you had to give. But I asked it not rhetorically, but for a purpose. I want to make just one brief statement.

EARLY COMPROMISE KEY TO TARGET SUCCESS

I hope that this administration will work with the leadership of this committee and the leadership of the House Budget Committee sooner rather than later, to fashion a compromise.

I believe the longer you wait this year to fashion a compromise the more difficult it will be. I believe we have within our grasp the ability to come close to meeting the GRH targets this year, not violate the basic principles the President believes in, and still come up with a reasonable proposal that has proper accord for all segments of this economy.

But if we wait too long to do it, election or no election, in my view, Director Miller, we are going to have a hard time.

One of the reasons I am glad to be on this committee is that I would like to take part in these negotiations during the next 3 or 4 months. Thank you.

Dr. MILLER. Thank you, Senator.

DON'T CHANGE TARGET—KEEP DOWNWARS TREND

Senator **Riegle**. Would the Senator yield just briefly, just for one question on that point, because I agree with him. I think we do need to have the compromise. I think the sooner we get to work on it the better; it ought to be bipartisan.

But is it also your view that we should not feel necessarily bound to an arbitrary target of $108 billion, if it turns out that to reach a balance, it is some figure different than that? Is the Senator open on that question, or not?

Senator **Rudman**. Well, I know that there have been some, including the chairman of the committee, that think the target ought to be moved this year.

I do not want to change the target. I think that if we leave the target in place, we keep the discipline in place to try to reach the target.

What I am saying is, that even if you miss a target by some amount of money, if you have a deficit plain which is steeply downward, then you are accomplishing the purposes of this statute. If that were to happen, I would be satisfied. But I do not think we ought to, by statute, change the target. In my view, if you change the target from $108 to $118 billion, then you end up at $138 billion. That is human nature.

Senator **Riegle**. I thank the Senator.

Chairman **Chiles**. Senator Lautenberg.

Senator **Lautenberg**. Thank you, Mr. Chairman. The temptation to respond to my good friend, and former chairman's comments is enormous, and I do not want to use my time there, except to say that he obviously feels more comfortable with the new majority. He has stopped smoking. He is less nervous than he used to be with the other group in charge.

Mr. Miller——

Senator **Domenici**. I will talk pretty soon. [Laughter.]

ADEQUACY OF FEDERAL PRISON SPACE

Senator **Lautenberg**. The budget is perhaps the most profound statement of philosophy or policy that is presented to us this early on in the year, and therefore, we have to contrast that or compare it to past declarations by the President, as to what he intends for the country.

Now, as an example, I would like to talk about prison population and prison space. Last year we passed a tough drug law. In 1984 we passed the Comprehensive Crime Control Act. Along with that comes tough new sentencing. Starting in November 1987 we are scheduled to have a tough new system that is based on guidelines that the Sentencing Commission is now working on. What does it all mean?

It means a lot more prisons. Since 1980, the prison population is up 75 percent. It has gone up three times as fast as prison space. We have over 41,000 prisoners today. With the drug law, we should have, we expect to have 67,000 in 6 years. That is over 4,000 a year more, and the Comprehensive Crime Act is going to mean even more than that. Where are we going to put them, Mr. Miller?

I want these drug dealers off the street, and all of us do. It is a national plague that we have got to deal with and we are determined to fight it by getting these people out of the community.

But this budget calls for actually a cut in prisoner spending.

Dr. MILLER. Pardon? What?

Senator LAUTENBERG. It calls for a cut in terms of what is needed, compared to the expected increase in the prison population. You are proposing 2,400 new beds, and when we see that budget, it is hard to convince the American people, I think, that we are really serious about getting these criminals off the street. The budget is saying our tough new laws will not increase the need for prisons, which is difficult to understand, or, it is saying wait until after the new sentencing guidelines are effective before we start dealing with the problem. We are just not going to have enough space to fulfill our commitment under these two major changes in the criminal code.

How do we deal with that, Mr. Miller?

Dr. MILLER. Senator, my figures show that the Bureau of Prisons will receive in budget authority under this budget $982 million as opposed to $877 million that was appropriated last year, and $606 million that was appropriated in fiscal year 1986.

Senator LAUTENBERG. Let's look at the construction budget, Mr. Miller, in terms of what the objective is with these changes in the law.

In 1987, we called for $219 million.

Dr. MILLER. Yes.

Senator LAUTENBERG. In 1988, we are talking about $210 million. Am I correct?

Dr. MILLER. Yes.

FACILITIES APPROACH LESS THAN EXPECTATIONS

Senator LAUTENBERG. If we extend that in 1989, we are estimating $135 million. How do we accommodate the objectives that we have by reducing the facilities construction budget when we have expectations of increases in population?

Dr. MILLER. Well, we are not reducing the facilities, we are adding to the facilities. We are adding monies. The money that is proposed for fiscal year 1988 is not quite as large as fiscal 1987, and I think that was somewhat more than the President had asked for in fiscal year 1987, in last year's budget.

Senator LAUTENBERG. But are we talking about comparisons to a baseline, or are we talking about comparisons to the need? Obviously the need is there.

Can we solve the problem, in your judgment, Mr. Miller, if the prison population is expected to expand at a faster rate than the facilities to house them?

Dr. MILLER. We do have a prison population problem and we have provided additional resources for that problem in the budget. I guess one could quibble about the precise numbers.

This was the best of our judgment after reviewing the matter in some detail. I would like to get back to you on a more definitive answer, if I could, Senator.

[The following was subsequently supplied for the record by OMB:]

PRISON CONSTRUCTION

Prison population forecasting is an inexact science. The Federal Prison System (FPS) projects that the Federal prison population will be 55,200 in 1993. The budget, particularly in the outyears, must be based on a certain set of assumptions that may well be subject to change over time. We understand that FPS is reviewing its long-range projections, however, we have not yet received them. We will certainly be open to reconsidering funding needs in subsequent budgets as time unfolds.

In the near term, BoP will have $429M for prison construction projects in 1987 and 1988. This is sufficient to fund seven new medium security prisons plus numerous expansion and renovation projects at existing facilities. In addition, FPS has $30M in unobligated funds from 1986 or earlier. Together this equals $459M. Outyear (1989-1992) increases provide funds for an additional 7,250 beds, bringing total Federal Prison System (FPS) capacity to 44,538 beds, and reducing the overcrowding rate to 25 percent from the current level of 47 percent.

Senator **LAUTENBERG**. OK. So what we are really kind of concluding here, or resigning ourselves to, is the fact that maybe we will not be able to do this job that we set out to with very recently enacted laws?

Dr. **MILLER**. I do not want to concede that, Senator.

Senator **LAUTENBERG**. I know.

Dr. **MILLER**. I believe that the amount that we have asked for is sufficient to meet those needs, but I will——

SALE OF AMTRAK

Senator **LAUTENBERG**. Let me get on to another subject since time is short. The sale of Amtrak. We have talked about selling Conrail, and of course that not only had some merit but some possibility. It is a profitable railroad. Now we talk about selling off Amtrak which is not a profitable entity.

We talk about a billion dollar recovery as a result of that sale. What assets do we sell?

Dr. **MILLER**. Well, I think the most likely means of the sale would be to sell the assets to a company that wishes to operate the railroad. We have found from our——

Senator **LAUTENBERG**. The nonprofitable——

Dr. **MILLER**. Could I finish, Senator?

Senator **LAUTENBERG**. Please.

TRANSFERS FROM PUBLIC TO PRIVATE DO BETTER

Dr. **MILLER**. We have found that it is almost universally the case, that when a commercial type operation is transferred from the public sector to the private sector, it does better in terms of the bottom line. It does significantly better.

We have a direct commercial type operation. The problem is the incentives tend to be wrong under government ownership and control than they are in the private sector. Now I realize that the Amtrak organization is not exactly the same as many other government organizations, but we believe it could be a lot more efficiently run as part of the private sector than it is today. And we believe that even though the cashflow is negative right now, it could be made to be profitable. It is not unlike the fact that a lot of times, the stock of companies, which, at the present moment, have a negative cashflow trade back and forth on the New York Stock Exchange

We believe that this operation can be turned around. There are enormous subsidies that are being provided right now, having very little to do with what is really, I think, a core operation in the Northeast Corridor.

Senator, I wrote a piece on Amtrak in 1978, and I will be glad to share a copy of it with you. The way it has operated, the incentive structure that it has is one that is going to be a continual drain on the taxpayers of America, in order to provide very large per person subsidies for those people who ride the train, especially in areas other than the Northeast Corridor.

[The following was subsequently supplied for the record by OMB:]

[From the Wall Street Journal, Aug. 25, 1978]

WHAT'S TO BE DONE ABOUT AMTRAK?

(By James C. Miller [1])

On May 1, 1971, Amtrak took over rail passenger service in the U.S. amid growing predictions that it would resuscitate traffic and, in a very short time, earn profits for its stockholders. Critics claimed this was preposterous. They argued that the only way Amtrak could get more passengers was to expand the system and offer extremely low fares—steps which would put the corporation further in the red.

The critics were right. During the past seven years Amtrak has halted the decline in rail traffic and has actually seen traffic rise an average of 8% per year. But the taxpayer subsidy has risen from $40 million the first year to more than $500 million this year, to an estimated $1 billion by 1984. Major reasons for the loss include a 17% expansion in the system and rate reductions that the bus companies regard as predatory.

When Amtrak started operations, taxpayers paid half the cost; now they pay nearly two-thirds. Not a single one of Amtrak's 41 routes covers its costs.

Proponents marshal many reasons to justify Amtrak. One that makes no sense at all is that rail service is a low-cost, comfortable mode of transportation.

THINK OF THE SAVINGS

According to the U.S. Department of Transportation, the typical Amtrak rider takes a trip of 226 miles. The cost to Amtrak of providing this service is approximately $44. Of this, the passenger pays just over $16, and nearly $28 comes out of the taxpayer's pocket. Since the typical competing air fare is only $24, the Amtrak rider could be provided with faster and more comfortable service at a savings of $2 to the taxpayer. But consider bus service, where the fare is only $17. This means that the taxpayer could give the Amtrak rider a free bus ride plus a newspaper to read along the way, add a complimentary three-martini lunch, and still have change to spare.

And despite massive expenditures to upgrade equipment, improve the road bed, and instruct personnel, it is still the case that, in the opinion of most Americans, Amtrak remains a second-rate service. According to a poll Amtrak commissioned, in not one of 12 major categories of service quality does Amtrak rank at the top. Indeed, Amtrak's performance has deteriorated to a point where only 60% of its trains run on time.

But other reasons for Amtrak have been advanced and deserve to be examined.

First, Amtrak is said to conserve energy. True, with high loads and efficient locomotives, Amtrak would use less energy per passenger mile than alternative modes of transportation. But the data show conclusively that on average Amtrak is only about one-half as energy efficient as the intercity bus, and outside the Northeast corridor Amtrak uses more energy per passenger-mile than even the automoble.

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[1] Mr. Miller is codirector of the Center for the Study of Government Regulation at the American Enterprise Institute.

Second, Amtrak is supposed to protect the environment. On average Amtrak does pollute less per passenger mile than either the automobile or the airplane. But it pollutes more than its chief competitor, the intercity bus.

The third argument is safety. True, Amtrak has a lower-fatality rate than either the intercity bus or the airlines. But fatality rates for all three are extremely low-less than one per billion passenger-miles (as opposed to 14 for the automobile). Curiously, even Amtrak's own poll found that most people regard air travel as safer than travel by train or bus.

Fourth, Amtrak is needed to reach isolated areas. The airlines serve far more places and carry almost 15 times as many passengers. Buses serve 30 times as many cities and carry over 17 times as many passengers; they also serve every single point Amtrak serves.

Proponents marshal many reasons to justify Amtrak. One that makes no sense at all is that rail service is a low-cost, comfortable mode of transportation.

Fifth, since other modes receive subsidies, why not Amtrak? This is hardly an argument. Airlines and buses pay their way through user fees (8% ticket tax for airlines, and four cents per gallon of fuel for buses). The local service airlines did receive over $70 million in operating subsidies last year, but this amounted to less than 5% of their revenue (versus 63% subsidy for Amtrak), or just about $1 per local service passenger.

Finally, Amtrak is available for use in an emergency. Many point to the 1973-74 energy crisis as an instance where rail service proved its value as a back-up system. True, during the embargo Amtrak's ridership temporarily increased some 46%. But even then, Amtrak accounted for only eight-tenths of one per cent of intercity passenger trips, and revenues covered only 56% of costs.

When it comes down to the bare essentials, the only real justification for Amtrak is that people are apparently willing to pay something just to have rail service around, even though they seldom, if ever, use it. Such justification is highly promoted by the formidable "rail passenger lobby."

But let's put this issue in perspective; $1 billion per year is about $4 for every man, woman, and child in this country. The question is whether that proverbial family of four is willing to pay $16 a year to support rail passenger service instead of going to an amusement park or taking several trips to McDonald's. (If any of you parents are wavering, just ask the kids.) In short, what is nostalgia worth?

Earlier this year Amtrak threatened to curtail service when it appeared that Congress would not approve the level of funding requested. The result was an emergency appropriation, coupled with a directive to the Department of Transporation that it assess the Amtrak situation and recommend a new network requiring less subsidy. On May 1, Secretary Brock Adams recommended that Amtrak's system be cut by 25%; that would reduce the subsidy by 18%, while decreasing ridership only 9%.

Secretary Adams's proposal cuts out many of the chronic money-losers but leaves three major transcontinental routes. While these "link the country together," they are very costly. The reason is that few people ride transcontinental trains. Not only is there little demand for long-distance rail travel, the service is frequently very inconvenient. (Trains often run through cities during the middle of the night.)

The Adams report outlines four additional alternatives, two more expensive, two less. My personal preference is for the least expensive, the one recognizing that rail service's comparative advantage appears to be in high-density, short-haul markets. This option would limit Amtrak's service to the Northeast corridor (principally Boston to Washington), the West Coast corridor (Oakland to San Diego), and a short-haul, spoke network out of Chicago.

THE QUESTION

According to the Department, cutting back the system in this way would mean a severe reduction in passenger-miles. But this is the only one of the alternatives that would hold subsidy needs to current levels. Such a bleak picture, of course, raises the question: Should we have Amtrak at all?

In any event, there is a compelling argument for some reduction in the size of Amtrak. As former Budget Director James Lynn used to say, the direction of change in the federal budget is often more important than the size of that change. But to reduce Amtrak's size will require a great deal of "statesmanships" on the part of those in Congress. Inevitably, there are immense pressures to expand the system.

As Amtrak Director Mary Head pointed out recently. "Most of the changes since 1971 have been directed by individual Congressmen or by other political means, usually in response to the pressure of constituents." And who can quarrel with a Congressman or Senator who is demanding that his or her constituents get some of the service? After all, they are helping to pay for it.

But this is a problem endemic to the government's running things that arguably should be left to the private sector. The trick is to avoid getting in the morass in the first place. Getting out is very painful and is seldom done.

Chairman **Chiles**. Senator Dodd.

Senator **Dodd**. Thank you, Mr. Chairman.

Chairman **Chiles**. Wait a minute. Senator Domenici.

Senator **Domenici**. I have to be gone by thirty after, so go ahead, Senator, and I will go——

CAN BUDGET BE PASSED?

Senator **Dodd**. I appreciate that. Mr. Chairman, I am delighted as well to be a new member of this committee. I think I am delighted to be a member of the committee at your request, to serve on the Budget Committee, and to wrestle with some of these problems.

I was intrigued, Dr. Miller, with a comment you made a few minutes ago, I think, to Senator Exon, regarding previous budgets that the administration has sent up here to Congress, and in your judgment, did not treat it with a great deal of respect.

Has it occurred to you that there seems to be a pattern developing over the last several years, that general reaction here, that maybe, just maybe, the problem does not lie here but might lie down there? You said you did not think this budget you have sent up here would be adopted by acclamation.

A very simple yes or no response would help to this question. Do you think there is a snowball's chance in hell the budget you have sent up here today, or this last week, has any likelihood of passing this Congress?

Dr. **Miller**. Well, I do not think I will respond to that with a yes or no answer. I think that this budget has quite a number of very important proposals—including some new things to offer, and I would hope that Members of Congress will read carefully what the President has suggested.

Senator, the thing that I was taking issue with is not the fact that after evaluation, a Member of Congress would disagree with not only certain parts of the budget, but maybe the budget overall. What I was concerned about——

Senator **Dodd**. Let me try and tell you what I am getting to here.

Dr. **Miller**. I am sorry.

Senator **Dodd**. There are a number of items in here, which regardless of where one comes from in the country, or whether one is a conservative or a liberal, a Republican or a Democrat, that just do not have any political support at all.

Now we can talk about reducing certain budgets in various areas, but eliminating funding for vocational education. Do you know of a Senator who would vote to eliminate all support for vocational education? Do you know one?

Dr. **Miller**. Well, I have not taken a survey, but Senator, the purpose of the President's budget is not to fashion a document that stands the maximum likelihood of passing the Congress by acclamation.

Senator **Dodd**. Did not suggest it should. Did not suggest it should.

Dr. **Miller**. That is not the purpose of the President's budget.

WAS COUNSEL SOUGHT ON BUDGET PROPOSAL

Senator **Dodd**. Did you call anybody? Have you talked to Bill Gray? Discussed this process with him?

Dr. **Miller**. Yes.

Senator **Dodd**. You discussed this budget with him?

Dr. **Miller**. I am not suggesting that the budget is reflective of Chairman Gray's——

Senator **Dodd**. No, I am not suggesting it is. But did you talk with him, did you talk with Senator Chiles, the staff, about this? What are the likelihoods of it? What do you think? Did we start this process before you came up here?

Dr. **Miller**. Yes.

Senator **Dodd**. You did?

Dr. **Miller**. Yes.

Senator **Dodd**. Senator, were there discussions about this budget?

Chairman **Chiles**. I do not think anybody asked me whether they should cut the funds for vocational education.

Senator **Dodd**. I do not mean specifically vocational education. But I am curious as to why this process does not begin earlier. That is my point here, really. I think you are getting a response, and we have over the last several years, and I do not say this disrespectfully, because no one wants to support that budget.

Why not begin that process ahead of time, where at least you can try to resolve some of those differences before we come up here? That is my point.

Dr. **Miller**. One of the difficulties, Senator, is that the Congress left town in the middle of October with 170 enrolled bills for the OMB to process, and to make recommendations to the President about, and to engage with him on, which took a great deal of time.

And then Congress wanted the budget produced a month early. Now I had the temerity of going out and saying to the press even, we cannot do it. We will present the budget in early February. Well, the leadership came down and spoke with the President, and talked about the need for getting the budget up in the first week of January, and after the meetings I talked with the President and told him the problems, and he said that he wanted me to get as much of the budget up as we could do.

Senator, I have been in my office every day for 5 weeks, and the people out here have been working very hard, and many times I have not been able to get Congressmen and Senators on the telephone, or visit with them on some of these matters.

I think we have done really a remarkable job in the time we have had.

Senator **Dodd**. Well, I would say I am not suggesting that you are not working hard down there at all. It just seems to me that we go through this process—I have seen in the last several years—we begin this way, everyone knows it is a bit of a charade, and then we go back through the process all over again, and we spend the next several months back and forth. I do not fault you, Dr. Miller, at all, in this process.

WORKOUT PROBLEMS BEFOREHAND

It seems to me that at some point I would like to see us begin the process where we ultimately end up, and that is beginning by trying to at least reach some sort of general agreement in areas where we know there can be some agreement, and where there cannot be, why we waste the time on it, is my point to you, really.

But I thank you for your response, and I thank you, Mr. Chairman.

Chairman CHILES. Senator Domenici.

ECONOMIC FACTORS DESTROY ESTIMATES

Senator DOMENICI. Mr. Chairman, thank you very much.

Let me inquire, Mr. Chairman, if I may insert this table from the January 2 letter from the Congressional Budget Office into the record.

Senator Nickles raised the point that when we left the floor of the Senate with the omnibus reconciliation bill, CBO had estimated to the best of their ability that we were within the $154 billion deficit target. Now we are at $174 billion. This table indicates the changes: for instance, revenues are about $11.8 billion lower because economic activity is slightly reduced.

I do not know what we can do about changes in estimates. We cannot change it every week. Incidentally, the best you can do is estimate what you are going to vote on. I mean, you cannot, every day, have somebody go out there and change the estimate, and find it changed by $2.9 billion. We were not wrong in the estimating. We were consistent. And I would just like that to be a part of the record for anybody that is interested.

Chairman CHILES. It will be a part of the record.

[The table referred to follows:]

TABLE 5.—*Changes in deficit estimate for fiscal year 1987*

[In billions of dollars]

CBO Estimate in Letter of December 8	150.6
Changes:	
National defense	0.3
Foreign military sales trust fund	0.9
Farm price supports	2.9
Deposit insurance	4.8
Medicaid and Medicare	3.0
Unemployment compensation	1.3
Assistance payments and supplemental security income	0.6
Net interest	−2.4
Other outlays[1]	0.6
Revenues[1]	11.8
Total changes	23.9
Updated CBO Estimate	174.5

[1] Adjusted for budgetary reclassification of certain receipts.

NEW BUDGET PROCESS—G-R-H

Senator DOMENICI. Now, with reference to the new budget process, in particularly, Gramm-Rudman-Hollings, could I ask you about three questions?

First, does the administration support as good economic and fiscal policy, the $108 billion target and the succeeding years' targets, assuming economic activity is on the plus side, as mandated in Gramm-Rudman-Hollings?

Dr. MILLER. Yes.

Senator DOMENICI. Now, second, on the Senate side, we have established a process whereby we measure outlays with each bill, and we crosswalk—that is, we allocate to the various 13 subcommittees of Appropriations—not only the programmatic authority but the outlay estimate for them to spend.

Dr. MILLER. Right.

Senator DOMENICI. We have been criticized, heavily, for putting that into law, because some people say it is too much of a straitjacket. Some people say we never have dealt with outlays, why should we now. Might I ask you: do you support that approach to budget reform, or not?

Dr. MILLER. I support that but there are budget reforms that you could imagine, some of which we have talked about, Senator, that would alleviate the need for that estimate to take place, and for that——

Senator DOMENICI. Well, you are assuming additional power in the President, either by way of line-item veto or enhanced rescission authority. Then you would not be as concerned about outlays. You could then make the necessary programmatic changes by further executive authority post-adoption of the appropriation bill?

Dr. MILLER. To give that up, I would see some additional changes. I would not identify them right now. But let me just say, everything else equal, I do have a feeling that if nothing else were to change, I would propose having the outlay requirement for the House as well as the Senate.

Senator DOMENICI. Now there are some who say, with reference to that outlay assumption again, Director Miller, that we do not know enough about it; therefore, we are shooting in the dark, making so-called "guesstimates", using a black box for your analysis a minute ago.

While I understand some of that is true, let me just ask: from the standpoint of overall budgeting, and the fiscal policy that results, do you believe the outlay estimating is something we ought to continue, and is it relevant?

Dr. MILLER. Yes, yes.

AGRICULTURE OUTLAYS UP

Senator DOMENICI. Yes to both questions. With reference to agriculture, do I have the numbers right? I am not in any way critical of any question that have been asked here about rural America and the expenditure of funds. But am I correct, that in 1980, the expenditures for farm subsidies was in the neighborhood of $5 billion?

Dr. MILLER. Yes.

Senator DOMENICI. And am I correct that for 1987 the outlays will be about $25.3 billion?

Dr. MILLER. Yes.

Senator DOMENICI. Are those not the same programs? Am I talking about apples and apples?

Dr. MILLER. That is exactly right.

Senator **Domenici**. Now I merely want to make an editorial observation, it probably means nothing, but, in 6 years we have increased the size of the program fivefold, if my arithmetic and costs are right.

Dr. **Miller**. That is correct.

MONEY DIDN'T CURE FARMERS' ILLS

Senator **Domenici**. And is it fair to say that the American farmer is not five times better off?

Dr. **Miller**. Is not five times better off.

Senator **Domenici**. Is the American farmer three times better off?

Dr. **Miller**. No.

Senator **Domenici**. Is the American farmer worse off?

Dr. **Miller**. Many of them are worse off.

Senator **Domenici**. I do not know what I conclude from that, but it does seem to me that if we spent $50 billion they would not necessarily be much better off. So I would hope that as we proceed through agricultural reform that we end up saying yes, dollars are terribly relevant, and programs and expenditures to the farmer are terribly relevant. But I also hope we address the issue that there is something basically amiss that does not have much to do with how much the Federal Government spends in price supports and direct payments to farmers. That we must address.

Would you agree with that assessment?

Dr. **Miller**. I would agree with that assessment, yes.

TWO-YEAR BUDGETING

Senator **Domenici**. Now with reference to processes, a lot of people say we ought to have a 2-year budget. I have never been for that, heretofore, but I am now for it provided it is a 2-year budget and 2-year appropriation bills for the basic appropriated accounts.

You have not been at this very long, but would you tell me: do you see anything patently amiss, anything that is apt to cause serious management problems, if we had a 2-year budget and 2-year basic appropriations process in the United States Government?

Dr. **Miller**. I do not. Let me say, I was something of a skeptic when I came into my present position, but I am much less skeptical now. I am inclined to think it is a good idea.

Senator **Domenici**. You are inclined to think that it is a good idea?

Dr. **Miller**. 2-year budgets are a good idea.

Senator **Domenici**. Now———

Dr. **Miller**. With the requisite flexibility to do supplementals and deferrals and so forth.

Senator **Domenici**. Yes.

Dr. **Miller**. Yes.

SUPPLEMENTAL IN SPITE OF RESCISSION CUTS

Senator **Domenici**. With reference to the supplemental, which I understand the President, through his respective Cabinet people, and yourself, are talking about presenting up here, is most of it for defense?

Dr. MILLER. Yes.

Senator DOMENICI. And most of that defense increase is for salaries, $1.2 billion?

Dr. MILLER. Some is for salaries, some for SDI, and other things, yes.

Senator DOMENICI. You have indicated that you are asking for rescissions to match up with it, right?

Dr. MILLER. Yes.

Senator DOMENICI. What will the administration's position be with reference to that big supplemental if we do not cut an equivalent amount somewhere in this government? Will you favor the sup anyway, or not?

Dr. MILLER. I do not think that I could answer that right now because it is predicated on Congress following its rules and making the offsets under Gramm-Rudman-Hollings as required by law.

Senator DOMENICI. Well, Mr. Miller, it would seem to me that if your answer is not no, you will not support it, then it seems to me that you are not in support of Gramm-Rudman-Hollings. There is no question in my mind that under the Senate interpretation of Gramm-Rudman-Hollings, and our rules, that there is no longer any room for outlays in the various subcommittees of the U.S. Congress, and thus we would literally be breaking——

Dr. MILLER. Be breaking the law.

Senator DOMENICI. Is that not correct?

Dr. MILLER. That is correct.

Senator DOMENICI. Well, I hope that that is taken into consideration in spite of the urgency or apparent urgency of need for the money. I do not think we should find the easiest excuses to break this, just because they fit the President's desire, or Senator Chiles or Pete Domenici's desires, of what we think we ought to spend money for.

Dr. MILLER. But let me just stress, we do have the offsets in the budget.

Senator DOMENICI. You do?

Dr. MILLER. And rescissions, yes.

Senator DOMENICI. But you have had them regularly for these sups, and Congress has never passed them, at least most of them they haven't.

Dr. MILLER. Right.

OLD ECONOMIES USED TO PRESERVE TARGET

Senator DOMENICI. And then they have added supplementary money anyway and found that we didn't really break the budget. Let me indicate to my friend, Senator Chiles, that the reason we are not going to break the budget on the House approach to this is—believe it or not—in spite of all the re-estimating they would use old economics. They will use the same assumptions we used when we passed it all, and we still have room under those assumptions. We have not broken the budget yet. That is rather interesting. When we already know we have really breached the ceiling by $20 billion, we will still go through the charade that we have not. Is that right? I mean, is that how we do it?

Dr. MILLER. Yes, I see your point.

Senator Domenici. With reference to the entitlement programs, how much do you propose to save in your budget off of entitlement programs, and how big are the entitlement programs that you are cutting from?

Dr. Miller. I gave Senator Lautenberg a copy of my paper that had this information on it, and I flipped back to another page.

Senator Domenici. Well, Dr. Miller, let me——

Dr. Miller. We have the entitlement programs divided into two categories, essentially, although the categories do not exactly bracket the CBO entitlement definition. We have major medical, which is $120 billion in 1988 current services, and $151 billion base for the other entitlements programs. So the sum of those two, about $271 billion.

Senator Domenici. And you are going to reduce off of current policy how much?

Dr. Miller. We are going to reduce off of current policy about $10 billion—a little more than $10 billion off of those two.

BANK FAILURES CAUSE PAPER RISE IN BUDGET

Senator Domenici. One last question. According to CBO's estimates, which are not final, as you know, and their estimate of your budget is not final at all, but nonetheless they show that for 1988 this budget is going to go up about $61 billion from just two sources. Or, excuse me—$50 billion of that $61 billion is from two sources; entitlements and non-defense discretionaries. Now, I do not understand how non-defense discretionary can go up as much as CBO is estimating.

Do you know at this point what caused that? I mean, I know about inflation. That is up——

Dr. Miller. Right.

Senator Domenici [continuing]. Four percent. But where did the rest of the increase come from? It is all over the place.

Dr. Miller. I will get you a breakdown of that.

[The following was subsequently supplied for the record by OMB:]

Year-to-Year change in CBO baseline for nondefense discretionary programs

1987 nondefense discretionary outlays	168.5
Inflation	2.7
One-time 1987 savings:	
Export-Import Bank loan asset sales	1.9
REA loan prepayments	2.0
RHIF loan asset sales	1.9
RDIF loan asset sales	0.4
Subtotal	6.2
Conservation Reserve Program [1]	1.2
Postal Service	1.3
Other	8.6
Total, year to year change	20.0
1988 nondefense discretionary outlays	188.4

[1] Prior to 1988 funded in CCC and considered mandatory. Beginning in 1988, appropriations will be required.

Senator Domenici. Is the increase due to things we did in that great big omnibus bill or is it——

Dr. **Miller**. Some of it is there. Oh, in the omnibus bill. I thought you were saying reconciliation. Some of the increase in the entitlement programs were in the reconciliation. As you know there were some outyear effects on the medical programs. Yes, it was in the CR.

Senator **Domenici**. Well, I understand a nice chunk of it comes from one of these bank guarantee programs, FSLIC or—we now find that——

Dr. **Miller**. What we found is that FDIC has reestimated the number of bank failures that they would have to take over so their outlays are $5.9 billion greater than we had anticipated just 6 months ago.

Senator **Domenici**. All of which counts as an outlay against the deficit?

Dr. **Miller**. Well, it is an outlay although there are assets that are secured. You go in and you essentially buy the bank. You have the assets of the bank but you score it all as an outlay. It is a scoring problem that does not normally give us a great deal of trouble, but this one does because it is such a substantial change from one year to the next.

PROCEDURE FOR NEW PROGRAMS TO ENTER BUDGET

Senator **Domenici**. My last question, just by way of process, I would like to know how our national government at the executive branch works. You know, after 5 or 6 years of fiscal restraint, whether we think it is great or not, we look out there at our country and some of us think that there are some new problems that we have not addressed. That is not by way of saying that we want to spend all the money in the world, but I see the mentally ill and homeless as a terrible American problem.

I see the infrastructure problem of the future as an increasingly difficult one. Major medical coverage for the senior citizens—I understand you debated that; did you not?

The major medical coverage, was that debated in the administration?

Dr. **Miller**. Yes, oh yes. And it still is.

Chairman **Chiles**. Are you going to send us up a catastrophic coverage?

Dr. **Miller**. The President will probably have some statement on that in his state of the Union.

Senator **Domenici**. All right. Now my point is this. Where in this process, as you prepared this budget, do those helping this President suggest new problems that are out there when we are all concerned about cutting things? Is there any substitution of a new program for an old program? How does that occur, Mr. Miller, and did it occur at all in this budget?

Dr. **Miller**. It occurred in this budget process in a number of ways. Of course there are cabinet meetings with the President. There are one-on-one meetings with the President. There are exchanges that take place among cabinet officers. There are formal presentations and proposals by the cabinet agencies and the other non-cabinet agencies in terms of their budget proposals and there is an exchange that takes place.

As you know, Senator, there are a number of new initiatives in this budget, but there is a process for raising those different priorities in the administration. It never works perfectly from one administration to the next, but the system is flexible to allow that.

Senator DOMENICI. Thank you, Mr. Chairman.

Chairman CHILES. Senator Riegle.

EARLY BI-PARTISAN APPROACH TO BUDGET PROBLEMS ESSENTIAL

Senator RIEGLE. Thank you, Mr. Chairman. I have listened to every bit of the cross-examination here today from Members on both sides and read the statements and I think we are at a point here where we may have an opportunity to really do something together, but it is a very fragile opportunity and in all likelihood it is going to get away from us unless we all reach for it at the same time.

I think you have heard enough today from both sides of the aisle to get a sense that the priorities in this budget are wrong in many respects. They are not realistic. Some of the cuts that you have proposed, like the elimination of vocational education, the cuts in Medicare, the cuts in education just are not going to take place and should not take place.

You include a substantial increase in revenues through user fees and so forth and we have seen a lot of those before. They have not happened and probably are not going to happen here. You have got a continued big defense increase. I do not think the support is there to make that large defense increase.

If you were to put this to a vote today in the Senate as a whole I do not think you would get five votes. And that means probably five votes—if you got them off your side I am not sure you would get a single vote.

So we are going to have to change this budget and what I would like to propose is that we get started in a serious bipartisan way to change it now and get this job done in the next 3, 4, 5 months.

And let me tell you why I say that. The President is finishing his second term. He has got 2 years to go. The Iran problem and the Contra problem has got the administration substantially, I think, sidetracked, at least in part on that issue, and the Congress is spending part of its time on it. And I think if we just go with the budget impasse and try to tough it out as we have done in previous years and let the year grind down and get too late in the year, I think that we are going to suffer undesirable consequences. I do not think anybody is going to be satisfied. I think we will have a worse product. I am willing to make cuts in areas that I support if it is part of a package that really gets the job done. I do not want to do that. I am prepared to do it because I think we have got to try to come in on these targets.

So what I would like to suggest to you is that we not tough it out. The stories in the press are that the administration is basically going to lay this out here and say, this is it and there will be sparring, but no real effort to try to take and strike a compromise.

BUDGET SUMMIT WITH PRESIDENT NEEDED

I think what the Senator from New Hampshire said earlier makes some sense. We ought to have a compromise. We ought to start to work on it now, and I am making a serious offer to you to work to try to develop that, because I think in the end the President is stronger, I think the country is stronger if we could find a way in the next 6 months to reach some kind of a reasonable compromise here with give and take and settle the issues and have a budget that has that kind of bipartisan support that the country wants and needs. I think we would be much better off.

But I think we are right now at the point where we are about to go down separate roads and I think that is a big mistake, and so I would like to encourage you to think about that. And I think many of my colleagues on this side of the aisle would join in a serious effort—something like a budget summit, meetings that would take place, either at this end of the street or down at your end of the street—not a single meeting but a series of meetings—to try to work something out here before the debate gets so hardened and so politicized and so frozen that we all end up losing. You are a serious professional and so are we and I do not want to see this year get away from us without reaching some kind of a sensible solution.

Are you open to that? Do you see a way that that might be done? What would the administration's attitude be on that kind of a serious effort, maybe some of it done behind closed doors.

Dr. MILLER. I think, Senator, if there is going to be such an effort there would need to be some preliminary discussions behind closed doors. As you know, it is very difficult to do something quite so bold as a summit because——

Senator RIEGLE. Well, let's give it a different name but let it be essentially the same thing, if that sounds too bold.

NOT WILLING TO RAISE TAXES

Dr. MILLER. People sometimes bring their preconceived notions, whether it is one side or the other, as to what is really on the table or not on the table. And I know my boss, the President of the United States, has very strong feelings about a couple of these parameters. And I guess we are a little bit sensitive about engaging in an open summit of some kind when an agreement to do that would be read by a lot of people, falsely, I think, as the President's putting things like taxes on the table. And he will not do that.

Senator RIEGLE. Well, maybe a way can be found to avoid that. You do have quite a bit of revenue here——

Dr. MILLER. Yes. There are revenue sources that we can work together on, I think.

Senator RIEGLE. You are proposing to do so. You are proposing to raise a lot of revenue, even if you do not call it taxes.

Dr. MILLER. That is right.

Senator RIEGLE. And so I would like to suggest those meetings——

Chairman CHILES. About $6 billion in there I think you have to call taxes. I mean, at some stage I do not care whose got the pulpit, there are some of those things you have got to call taxes.

Dr. **MILLER**. Maybe we should not put those in there. [Laughter.]

Chairman **CHILES**. Well, then if there are $6.5 billion then we have established what our profession is and we are arguing about the price.

Dr. **MILLER**. I knew that was coming.

Senator **RIEGLE**. Well, I will just finish because my time is up.

Dr. **MILLER**. It is of a special variety, as we discussed before.

Senator **RIEGLE**. This President will not be President after the next 2 years is over, and I think it is in his interest and the country's interest that this be a productive 2 years.

Dr. **MILLER**. Yes.

Senator **RIEGLE**. And I think that, particularly now, a stalemate is dangerous. I think there are economic dangers in that that hurt everybody and threaten everybody. So I just want to say, again, that I think if we try to have a serious effort to find a balanced answer that avoids a kind of budget paralysis, the country would sure come out ahead as a result of it.

Dr. **MILLER**. Thank you.

Chairman **CHILES**. Senator Wirth.

REVENUE GAINS AND LOSSES DUE TO TAX BILL

Senator **WIRTH**. Thank you, Mr. Chairman, and I am glad to be on the Senate Budget Committee after 6 years on the House Budget Committee. It is a pleasure to be here and Dr. Miller, I thank you for the long and patient morning with all of us.

The first question I have relates to the revenues assumed in the budget as a result of the tax changes from the tax bill. As I remember, 4 months ago when we were going through the final discussions on the tax bill, there was an assumption—correct me if I am not accurate that we would gain some $11 billion this fiscal year——

Dr. **MILLER**. Yes.

Senator **WIRTH** [continuing]. But there would be some significant loss the next——

Dr. **MILLER**. $15 billion loss in receipts and a $1.7 billion increase in outlays for a net deficit effect of $17 billion.

Senator **WIRTH**. Seventeen. Is that $17 billion loss assumed in your budget.

Dr. **MILLER**. No, the numbers that you cite were the products of the Joint Committee on Taxation as they tried desperately to price every subsequent variation of the tax reform bill as it was being put together.

Senator **WIRTH**. Those were the Treasury Department numbers as well; isn't that correct?

Dr. **MILLER**. No, no. They were Joint Committee estimates——

Senator **WIRTH**. Are you sure?

Dr. **MILLER**. Yes. They were Joint Committee on taxation estimates under CBP's August economic assumptions. Since then the Treasury has made their own estimates under the administration's economic assumptions.

Senator **WIRTH**. You might just check that and make sure——

Dr. **MILLER**. I will be glad to check that. Since that time the Treasury Department has had a chance to review the language of the legislation in more detail and the numbers are different from those that you just described.

Keep in mind we are talking about reasonably small difference between some very large numbers. Tax receipts estimated under the old tax system——

Senator WIRTH. What are the numbers in this budget that account for the loss from the tax bill for fiscal year 1988?

Dr. MILLER. The estimates in this budget assume $0.9 billion in additional receipts and $1.7 billion in additional outlays for a net budget deficit effect of $0.8 billion.

Senator WIRTH. You are only assuming a $1 billion loss. Can you provide to the committee what differences there were between the $17 billion and $1 billion figures? I mean, this is——

Dr. MILLER. I do not know whether I can give you a bridge table, very detailed——

Senator WIRTH. But something pretty dramatic happened. I mean, this is $16 billion that you have wonderfully found. I am all for it. I mean, we all want to see as low a deficit as possible but——

Dr. MILLER. Well, I think other estimators are coming in with some numbers very similar. You see, what you had was a number of things—a number of changes in the tax code and the numbers that came out of that process were based on essentially models that had been calibrated on the old tax code.

Senator WIRTH. Can you get the——

Dr. MILLER. And there has been a process of updating

Senator WIRTH. Can you get your staff at OMB to give us a summary of those differences. I mean, a lot of us were pretty concerned, when that tax bill passed, about a big tax loss and I think it is appropriate that we understand that that is not a reality anymore and that we do not have to worry about that.

Dr. MILLER. Right.

[The following was subsequently supplied for the record by OMB:]

SUMMARY OF DIFFERENCES

The principal reasons why the Treasury Department estimates included in the President's 1988 Budget differ from the September 18, 1986 JCT estimates are:

An ESOP/estate tax provision of the Act was not properly estimated by the JCT;

Apparently greater responses in taxpayer behavior resulting from changes in the taxation of long-term capital gains assumed by the Treasury;

Differences in the underlying economic forecasts used to make the estimates and in the year-to-year timing of the revenue changes.

Among the provisions that are especially sensitive to the economic forecast are:
Individual tax rate cuts,
Corporation tax rate cuts,
Investment tax credit repeal, and
Personal exemption and standard deduction liberalizations.

Senator WIRTH. As you know, there is an enormous amount of discussion up here and across the country about so-called competitiveness and the package of investments that we ought to be pursuing at the Federal and state level, as well as within the private sector, to increase the competitiveness of the United States and our productivity. I was pleased to see in the budget that you have proposed a significant increase for the National Science Foundation, something which I have long advocated.

EDUCATION CUT SIGNIFICANTLY

I was, however, not as pleased to see the corollary of that, which is investment in education, cut quite significantly in the budget. The thrust of my question is, have you all looked at a so-called competitiveness package, and if so, is there a way in which you can define what we ought to be doing and what the administration's perspective on a competitiveness consists of?

NUMBER OF STUDENT LOANS NOT AFFECTED

Dr. MILLER. Senator, let me respond in two ways. One, I think the President will address this generic issue in his state of the Union message. Secondly, let me say that what we did in education, bear in mind, is that we have proposed to reduce the subsidy element in the guaranteed student loan program, but as many individuals would have opportunities to go to school.

Furthermore we are changing it——

Chairman CHILES. Would they if you cut the Pell Grants?

Dr. MILLER. Pardon?

Chairman CHILES. Would they if you cut the Pell Grants?

Dr. MILLER. Yes, we think so, roughly speaking. What we want to do——

Senator WIRTH. What do you mean, roughly speaking? We are talking about education. We are going to cut student loans and then the chairman asked you if under the proposed cuts in Pell Grants, the same number of people would go to school, and you said, yes, cutting Pell Grants the same number of people would go. How does that add up? Two plus two equals what?

Dr. MILLER. You are looking at the money top line. You can cut the amount of subsidy. Let's suppose you have a given amount of money and you cut the subsidy per loan in half, you could have twice as many loans on the same amount of money. While the money is being reduced the subsidy element is being reduced as well.

But what we would like to move to is a system where——

Chairman CHILES. But you would have a different mix of those able to go to school then, wouldn't you?

Dr. MILLER. No; if I could just be allowed to finish. What we are trying to move toward is a system where anyone who wants to go to a school of higher education can obtain a loan to do that. But we would reduce the outright subsidy element. We would also, in this budget, increase the income contingent loan program. That is the kind of loan where you might have a low income person who goes to school and immediately thereafter would not catch up in terms of income and you would stretch out the payment cycle for those individuals.

So we think that this program, while it does reduce total outlays, is more carefully crafted to direct to the basic need of the individual in going to school is that they cannot use their human capital as collateral.

BUDGET SUMMIT WITH PRESIDENT

Senator WIRTH. My time has expired, Mr. Chairman. But I would like to echo what the Senator from Michigan was suggesting about a budget summit. I think that that is absolutely imperative. The time is now. You have got a willing and able chairman on this side and a ranking minority member who understand this process. They have worked together for a long time.

I think the House is ready, and I think it is in your court to call that sort of a session. I do not think anybody would assume that by calling it you are saying you want to raise taxes. I think it is imperative that it be done immediately, that we bring all the parties together and get after this question. I think this is the year in which to do it, before Presidential politics start to heat up for 1988.

So I would urge you to go back with my message and that of the gentleman from Michigan and, I suspect, many of us Thank you very much.

Dr. MILLER. Thank you.

Chairman CHILES. Senator Conrad, I think you had another question you wanted to ask.

Senator CONRAD. I do. Thank you, Mr. Chairman.

CRISIS IN AGRICULTURE

Mr. Miller, I want to take you back to agriculture. I do it because it is truly a matter of survival for many people. I mean, I cannot overemphasize how serious the crisis is in my State and in other farm belt States as well.

When I was talking about cuts you suggested that we are talking about a timing difference, and that may be for 1 year. But if we look at the thrust 1988, outlays of $26 billion, 1992, outlays of $13 billion we have cut spending on agriculture in half. And I understand full well the point that Senator Domenici was making that that still leaves us with government spending far higher than it was when we started in 1980 and 1981.

But the point is, at the same time we have had an administration strategy to cut prices by dramatically cutting the loan rate. And as a result of that we have had farm prices experience steep declines. The offset was that the government was going to provide more money to fill in part of the gap. And you must realize, we have lost more in the market place than we have gotten by the increase in government expenditures.

So now you come forward with a budget proposal that says nothing about doing something on the price side of the equation but dramatically cuts government support over 5 years. And you talk about attrition, which is a kind word for saying farmers are going to get pushed off the land. And really, it strikes me that we are abandoning agriculture and abandoning farmers, absent some coherent strategy for increasing price.

You rejected here today any move to get together with the other major producers to do something about the supplydemand imbalance. So I would come back to you and ask, what do we do about the crisis in agriculture? It is not enough It is not enough to say we are going to cut agriculture programs in half in terms of what government does unless there's a strategy to increase price. And I want to know that that price strategy is.

Dr. **Miller**. Senator, let me apologize to you. I realize now that I misinterpreted your question. When you said get together with major producers I thought you were talking about major domestic producers. I think what you meant were——

Senator **Conrad**. International.

Dr. **Miller** [continuing]. Our international competitors. Obviously, this problem is international. It is not just a national problem, and we are working very hard. In Punta del Este we have got agriculture on the agenda. We are going to be pushing that very hard with our GATT partners. I think there is a lot that can be accomplished there.

We have a comparative advantage in agriculture. We should be exporting agricultural commodities. A problem that we have in our present system, it is such a jury-rigged system, and it has incentives that make matters worse rather than make them better. I think we have observed that during the past year.

I think we need substantial reforms in it, and that is what the President has proposed and the Secretary of Agriculture have proposed.

SUMMIT OF AGRI PRODUCERS

Senator **Conrad**. Let me just pursue this if I might. Are you then in agreement with the notion to have a summit? We have talked here about a summit between Congress and the White House on the question of the budget. Is it possible that we could have a summit of the major agricultural producers—and we are only talking about five or six that would really matter—to talk about doing something about the supply-demand imbalance so that we could support a reasonable price in the market place?

GNP GROWTH RATE

Dr. **Miller**. Well, as I indicated, there are very high level discussions going on and negotiations going on over this problem in our GATT round. And, of course, I would not be surprised--I do not want to speak too soon on this—if that issue were on the agenda when the leaders of the nations hold their next economic summit.

Senator **Conrad**. Let me just make one other observation. The growth estimates are of concern to me. Last year 4-percent growth was estimated. We are getting 2.7 percent. This year, as I understand it—you have got 3.2 percent growth as a base assumption here; most economists are looking at 2.6, 2.5 percent. So, there is a significant difference between the growth estimates. Would you speak to that?

Dr. **Miller**. Well, keep in mind economists predicate their forecasts on the basis of what they estimate Congress will do in the area of fiscal policy. I have more confidence that Congress will get the budget deficit down than many private forecasters. If you look at the budget deficit estimates you will see that most of these private forecasters do not believe that Congress will bring the deficit down to $108 billion.

This budget is predicated on that assumption. If it proves to be false I doubt that we will have the economic growth that we project. But our projections of economic growth are predicated on the assumption, as built into this budget, that Congress will get the deficit down.

Senator CONRAD. Mr. Chairman, if I might indulge, could I make one more comment before we—I understand my time has elapsed.

Chairman CHILES. Yes, sir.

Senator CONRAD. What would be so wrong——

Chairman CHILES. You are only intruding on my time, Senator.

Senator CONRAD. Well I would recede from that. Go ahead.

Chairman CHILES. Go ahead.

Senator CONRAD. What would be so wrong with two elements—somebody asked, what do you do? I think you turned the tables on the Congress here and said, what do you do? What would be so wrong with a more aggressive effort on attacking the tax gap. I understand there is a couple of billion dollars in here. It is my view, after serving as a tax commissioner and having what I called a fair share program at home, there are some major dividends there. We got $15 for every dollar we invested in a fair share program in my state.

DEFENSE COSTS HURT AGRICULTURE

I believe you could make major inroads on the tax gap, the some $100 billion that is out there that is legitimately owed and due that is not being paid. And on the flip side, on the spending side, what would be so wrong with saying to our allies in Japan and western Europe, it is time for you to pay more of your fair share of the defense costs.

It strikes me as very difficult to accept cutting agriculture in half when we are spending over $100 billion a year to provide the defense umbrella for western Europe and Japan at the same time they are enjoying tremendous trade balances with us. Part of the reason I think that is happening is that while we are providing the defense umbrella for them, they take the differential and invest it in consumer products and kick us in the international market place.

What would be so wrong with a major departure from how we have been doing things?

Dr. MILLER. You had two questions. One, with respect to Japan, I think we would have to change their constitution to accomplish that.

Senator CONRAD. No, they have gone passed the 1 percent. They have just exceeded the 1 percent in their latest budget. I do not see any reason that they could not bear a larger portion of their defense costs.

IMPROVE UNPAID TAX COLLECTION ABILITY

Dr. MILLER. Well, I think one of our strategies is at every opportunity to obtain greater support from some of our allies. On the question you asked about tax, was your description of a tax amnesty program? Is that what you were proposing?

Senator CONRAD. No, although that could be an adjunct. In my State we started what we called a fair share program, where increased the expenditure for the revenue service to go after the tax gap. The difference between what is being paid and what is legitimately owed is staggering. As you know, it is over $100 billion a year according to the revenue service.

Dr. MILLER. We have increased rather significantly the resources going to the Internal Revenue Service in this budget, and in addition to the IRS initiative that was contained in the appropriations measures.

Senator CONRAD. Why not go further? The tax gap that is out there is $100 billion a year according to the revenue service. In our experience we got $15 for every additional dollar that was invested in compliance. Why couldn't we be more aggressive on the Federal level? The tax gap was $40 billion in 1976. Now it has mushroomed to over a $100 billion. I do not understand why we cannot be more aggressive in attacking that tax gap.

Dr. MILLER. Well, I mean, this is something that we monitor at almost constantly. There is a question of how much resources, even if you could work the last ounce out, you could probably adopt half the nation's resources in the pursuit of unpaid taxes and not get the number down to zero.

Senator CONRAD. You know, the effective audit ability of the revenue service has been cut in half in the last six years. The effective audit ability of the revenue service has been cut in half. We have let this tax gap grow. I think it is terribly unfair to the honest taxpayers to allow that system to proceed.

Dr. MILLER. We have also—well, I will stop on that right now.

OUTLAYS FOR DRUG REDUCTION INITIATIVES CUT

Chairman CHILES. Dr. Miller, in looking through your budget materials a little closer I have found, to my disappointment that the President proposes to terminate both the omnibus drug bill's health and law enforcement assistance grants. A 50 percent cut has been proposed in the funds intended for drug abuse prevention in our Nation's schools, and the customs interdiction program would also be cut in half.

My home State of Florida stands to lose at least $39 million from these four programs alone. At a time when the President is claiming a strong commitment to fighting the drug war the idea of eliminating aid of this type to all States and localities concerns me a great deal. We just claimed we passed a major drug bill last year and the President joined in that proclamation, along with the Congress.

I wonder if you could shed some light on the thinking behind these proposals. How can we take away this important assistance from the very entities which help the Federal Government combat drug abuse in schools and provide treatment for those that seek it and assist us in the Federal antidrug campaign?

Dr. MILLER. Mr. Chairman, as opposed to fiscal year 1986, this budget contains enormous sums for drugs. In some of these areas, we do not renew these very large $250 million grants to States.

Chairman CHILES. We had a maor drug bill in 1987 and before the elections, both parties claimed that we were making a major effort. Are we now going back on that?

Dr. MILLER. No; if I could finish answering, I did not misspeak. I said 1986. I did not say 1987; I said 1986. There were $250 million grants to States that the President did not support; he opposed, the administration opposed.

We believe that these monies are not well justified, but there are very large sums in this budget for purposes of drug enforcement, reducing the consumption of drugs.

Chairman CHILES. Has it not been our experience and was not the thrust of the drug bill deciding that we could do it all on the enforcement side?

Dr. MILLER. Right, sure.

Chairman CHILES. We had not been successful. We were spending $1.4 billion a year at the time we passed it. Yes, we were going to try to provide some additional money for enforcement. But for the first time we were going to pass some drug education programs and some rehabilitation programs, and we were going to assist State and local government in trying to fight the problem.

Dr. MILLER. Right. Well, Senator, no one in the administration is in favor of drug abuse.

Chairman CHILES. Obviously, we know that.

Dr. MILLER. No one, I think, here in the Congress is in favor of drug abuse. We had, last year, a very important drug measure passed. At the last, it got to be something of a race to see who could add more money in various areas.

We propose in this budget an amount consistent with what we think can be very usefully employed in the pursuit of this goal.

LAW ENFORCEMENT NOT ONLY DRUG CONTROL TOOL

Chairman CHILES. Where is the thrust from the Federal Government to promote education against drug abuse, and where is the thrust to provide treatment?

Now, we are going forward and saying if we catch you, we are going to put you in jail, although you have cut back some on the prisons, too, and that is another thing I think we need to deal with.

But are we not just backing off and saying we are going to do it all on the enforcement side again?

Dr. MILLER. Oh, no, not at all. You are correct, in that the major thrust of the drug effort was to cut down on the demand side. I mean, in the past our effort had been directed almost entirely to the supply side.

There was a recognition, I think, on all of us that in terms of eliminating drug abuse, we could more effectively employ resources at the margin on the demand side, and that is what the drug initiative was about and I think this budget reflects those priorities.

We have a lot of money in HHS; we have a lot of grant programs to State and local governments that can be used for drug abatement, for reduced consumption.

Chairman CHILES. It looks like you are really backing off that trigger money that we put in to encourage the States to put in meaningful K through 12 drug education programs. That was the thrust of what we were trying to do in the bill.

Now you come up in the first year after that and propose cutting that funding. I do not think that makes much sense.

Dr. MILLER. Well, I will be glad to engage in further colloquy with you, Senator, and provide you some views in writing on that.

Chairman CHILES. Fine.

[The following was subsequently supplied for the record by OMB:]

VIEWS ON DRUG EDUCATION BUDGET PROPOSALS

The administration is strongly committed to helping States and localities implement effective drug education programs. The $200 million level appropriated in 1987 for the new Education Department program will help finance the significant costs associated with initial planning and implementation of school and community-based programs across the country. We, just as you, view this funding as "trigger" money to encourage States and local school systems to do more in this area. Our request for $100 million for these activities in 1988 reflects our expectation that States and localities will build their capacity to maintain these programs and will eventually assume full responsibility.

Chairman CHILES. Senator Simon.

Senator SIMON. Thank you, Mr. Chairman.

Dr. Miller, we are happy you are here and let me just add I am pleased to be a new member of this committee.

Chairman CHILES. We are delighted to have your expertise.

Senator SIMON. I served for 6 years on the House Budget Committee so it is not completely new territory to me. Let me just add, since the Chiles-Domenici combine is up here, I also remember when we had a Muskie-Bellmon combine.

I think this past year, we really had a pretty good bipartisan effort emerge, and my hope is that that can happen once again. Let me add one other point just so I get it in the record now because I know pressure is going to grow on this.

SUPPORT FOR G-R-H TARGET

I am not going to vote to move away from the $108 billion target. I think we ought to stick to it. I think the deficit is the number one economic problem in this country, and I think my colleague from New Mexico is absolutely correct when he says without some pain we are not going to get where we ought to get and we have to be willing to move in that direction.

GNP RATE FORECASTING

Now, if I may, Dr. Miller, I have been looking over OMB forecasts and then what happens in growth in GNP. So far, I have not found a single year under any administration where the OMB forecast is not rosier than what has happened. Is that correct?

Dr. MILLER. I think 1984, OMB underestimated real growth. There is one.

Senator SIMON. 1984. Well, that is contrary to—— well, I do not have 1984 here, sorry.

Dr. MILLER. Maybe the deficit was higher; maybe that is what you were thinking.

Senator SIMON. OK, all right.

Dr. Miller. But real economic growth was higher than the estimation.

Senator Simon. But if we were to reverse our roles and you were a member of this committee, on the basis of history you would view with a little skepticism whatever OMB presented in the way of forecasts, would you not?

Dr. Miller. Senator, I would say what a wonderful budget had been developed. [Laughter.]

I think the historical evidence tends on the side of showing that the actual growth rates on the whole have been lower than the estimates, as you point out, from one administration to the next, I think.

Senator Simon. Yes. I do not mean to be criticizing this administration.

Dr. Miller. Part of the problem is that it is a particular difficulty because when you send up the budget, you are predicating your estimates of growth on Congress incorporating all of the recommendations made by the President.

And not surprisingly, each President believes that these recommendations would be more likely to yield economic growth or higher economic growth than the alternatives, and that is one reason, Senator, I believe that you will find this from one administration to the other.

Senator Simon. It is one reason, but not the only reason.

Dr. Miller. Maybe so.

Senator Simon. Yes.

Just one footnote to all those fine graphs you had here. I think we ought to be using the gross interest expenditure a little more frequently than we do. We use the net.

Dr. Miller. I will give it to you, sure.

[The following was subsequently supplied for the record by OMB:]

One possible definition of gross interest is interest on the public debt plus interest payments for funds of tax collections.

GROSS INTEREST

[In billions]

	1986	1987	1988	1989	1990	1991	1992
Current Services	192.0	193.4	200.9	209.9	215.1	218.8	215.1
President's Budget	192.0	193.0	200.0	207.3	210.3	211.5	203.2
Difference	0.0	0.0	−0.9	−2.6	−4.8	−7.3	−11.9

USER FEES

Senator Simon. Yes. and then finally one question; I would be interested in your philosophy on the user fees.

Dr. Miller. Well, the government engages in a number of activities that economists would identify as classic public goods, such as national defense. I mean, you defend one person, you defend them all.

The Government also produces what an economist calls classic private goods; that is, producing a service provided to a particular individual. Now, it gets kind of complicated when you provide welfare that goes to a particular individual, but the reason that it is provided is because people in general want the redistribution to take place; that we who are better off want to take care of this person who is not so well off.

When you come to, say, a national park, it is a mixed public-private good; that is, we have national parks because we want them there to preserve for the future and perhaps for our visiting at some point.

But there are also people who visit the public parks who impose direct costs that are attributable specifically to them. In most areas in Government, you could draw the analogy in the same way that the revenues generated, do not begin to cover the costs.

And so our proposal is to begin to price these things a bit more in a way that makes some sense, and we have a long list of user charges and that is the philosophy behind it.

CIGARETTE USER FEES

Senator SIMON. I understand, OK. Now, let me take you one step further, then. Let us take the case of cigarettes and the medical costs that we face because of cigarettes.

Could we not, in a sense, without violating this tax increase you are talking about—have a user fee on cigarettes that, in fact, would reduce that deficit and that is completely in line with the philosophy you are talking about?

Dr. MILLER. Senator, the theory is directly applicable and we do have a user fee. The question then is how much, and I do not at this point have in mind the relative analysis to say whether the current user fee is the right amount or it is too little or too much.

Senator SIMON. I hope you will take a look at that. I think we ought to take a look at that.

Dr. MILLER. Could I just mention as an aside, probably what is much more relevant is what the President thinks than what I think, between the two of us. The President has indicated a resistance to entertaining any further increase in the cigarette excise tax.

Senator SIMON. I understand, but we are in this give-and-take business.

Dr. MILLER. I just wanted to get that on the record.

Senator SIMON. I understand, but it is possible you are going to be seeing the President more frequently than I will.

Dr. MILLER. Right, yes, sir.

BUDGET SUMMIT WITH PRESIDENT

Senator SIMON. And you will have a chance to discuss where can we make some practical compromises, and I would add I hope that at some point there can be a minisummit with Senator Chiles, Senator Domenici, their counterparts from the House and you and the President and whoever else you want where we can talk about these kinds of compromises, where we can talk about the question that Senator Chiles addressed to you, and where you say we will put some kind of a revenue increase on, with the stipulation that it comes off when we have that balanced budget.

Within the confines of what you have set out, I think there are some practical compromises that can be achieved, and I think we have to say they have to be achieved if we are going to do what we ought to do responsibly.

Thank you, Mr. Chairman. Thank you, Dr. Miller.

Dr. MILLER. Thank you, sir.

Chairman CHILES. Senator Domenici.

WELFARE TO THE HOMELESS

Senator DOMENICI. Let me violate something that I normally will not do around here. I do not normally ask in these hearings specific questions about programs, but I feel compelled to ask you about one.

As part of the drug bill, Congress passed a very interesting change in the number of our entitlements that have to do with homelessness. We basically said that in all of the bureaucracy, you can no longer use residency as a test for VA benefits, as a test for AFDC, or as a test for benefits of one type or another.

Obviously, the reason is patent. I mean, if you have homelessness in the streets, they do not have a residence, right?

Dr. MILLER. They do not have a home.

Senator DOMENICI. We did the same thing on the foodstamps, Doctor. We said you do not have to have a residence, but we also told the department, we would like them to come up with a plan where people who get foodstamps and are homeless have a chance to use them.

Again, you have a definition problem. If you do not have a home, you cannot use foodstamps to buy groceries to take home and cook. So we asked them to come up with a plan to let them use them for their subsistence as they move through this status of homelessness.

I wonder if you would mind, Mr. Miller—I am sure my friend, Senator Chiles, would join in this request—giving us a quick report as to how the various departments are moving to implement this. Could you inquire of them?

Dr. MILLER. I will do that.

Senator DOMENICI. They were told that they had to come with a plan.

Dr. MILLER. Right. You know, that is one of the tragedies of the homeless problem is that a lot of these people are eligible for foodstamps, for VA benefits, for social security, and why are they not getting them? I will do that. That is one of the things that we will do better on.

Senator DOMENICI. You indicate correctly that that is one of the tragedies. Please do not assume that I believe that is the extent of the problem.

Dr. MILLER. Nor do I.

Senator DOMENICI. I think it is a serious part of the problem. Let me just give you an example. If, indeed, 35 percent of homeless people are seriously mentally ill—and I understand that may be a right number, and of the women that are out there, it looks like maybe 70 percent are seriously mentally ill.

Now, look at the problem you all have when we tell you to help them. But the people you need to help are not mentally able to seek help.

Dr. MILLER. Right.

Senator DOMENICI. You have to set up these little trusteeships. Who is going to get their checks? We now know that they are getting checks and some people are even waiting to steal checks from them.

Dr. MILLER. Right.

Senator DOMENICI. So we cannot do it the way we have been. I mean, you all have to come up with some plans to implement the program.

Dr. MILLER. Right.

Senator DOMENICI. So if you could give us a quick little report, we do not want to impose on any other committee's jurisdiction, but I think we would like to see what is happening.

Dr. MILLER. Yes, we will do that.

Senator DOMENICI. Thank you very much.

Chairman CHILES. Thank you.

[The following was subsequently supplied for the record by OMB:]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

22 JAN 1987

Honorable Pete Domenici
United States Senate
Washington, D.C. 20510

Dear Pete:

As you requested during the recent Budget Committee hearings, I am pleased to report to you on our progress in implementing the provisions of the drug bill concerning providing benefits to the homeless. As a preface, let me assure you that we plan to make every effort to ensure that eligible homeless individuals are being served.

Programs are in place for the SSI and VA benefit programs, which are administered at the Federal level. Both the Social Security Administration (SSA) and the Veteran's Administration (VA) have instituted operational plans for serving the homeless under which their field offices are required to undertake specific initiatives in order that the homeless receive information about their programs and any benefits to which they may be entitled.

These initiatives include identifying and maintaining a liaison with providers of services to the homeless, e.g., shelters, soup kitchens and churches, to locate homeless people who may qualify for SSI or VA benefits. These organization's staffs are provided training to identify potentially eligible individuals. Once identified, the organizations notify staff in the appropriate field office who will travel to the facility to take the application. In areas with large homeless populations, the SSA and VA staffs will periodically visit facilities for the homeless to screen and enroll applicants at the site.

When a homeless person's entitlement for benefits has been established, both VA and SSA will make special arrangements for delivering benefits and notices. They can be sent to a shelter or interested and responsible third party, delivered to a post office for general delivery or to a field office for pick up, or deposited directly into a bank account. If the homeless beneficiary is not mentally capable of managing his financial affairs, both SSA and VA will act to designate a third party payee. This may be a friend, relative, or organization who agrees to be legally responsible and accountable for managing the beneficiary's money. Periodically there is follow-up to ensure that the best interests of the homeless beneficiary are being served by the representative payee.

The remaining programs -- AFDC, Food Stamps, Medicaid, and Job Training -- are administered by the States or local organizations. Action is being taken at the Federal level to ensure they carry out the provisions in the drug bill. The Food and Nutrition Service (FNS) issued a final rule in May 1986 clarifying that a fixed address is not required to receive Food Stamps. HHS is drafting rules or guidelines to clarify that AFDC and Medicaid benefits are not to be denied to otherwise eligible individuals because they lack a fixed address. The rules or guidelines are scheduled to be finalized within the legally mandated deadlines. As an interim measure, the Health Care Financing Administration (HCFA) will be transmitting to the States a revision to the State Medicaid manual to clarify the eligibility issue in the next few weeks. It has been the general policy of the AFDC, Food Stamp, and Medicaid programs that the States not deny benefits simply because an individual does not have a fixed address, although some instances of denial apparently have been reported. It is our intent that these rules end this practice entirely.

In addition, the FNS is drafting a rule to implement the drug bill's provision which allows the homeless to use Food Stamps to pay for meals at a public or private nonprofit shelter. The Department of Labor (DOL) is also drafting a rule designating homeless individuals as a target group under the Job Training and Partnership Act. The FNS rule is scheduled to be completed by the mandated April 1, 1987 deadline and the DOL rule, which does not have a mandated deadline, will be finalized within the next several months.

Furthermore, SSA and FNS are developing a single SSI and Food Stamp application to be used during the pre-release screening of individuals in public institutions. In the interim, SSA case workers are completing both applications for the individual by transferring the relevant information from one form to the other. Providing benefits to those eligible individuals upon their release from public institutions will greatly ease their transition into the outside world.

Because I know you are deeply interested in the problems of the homeless, I thought you would be interested in knowing how our FY 1988 Budget affects them. I also thought you might be interested in some special initiatives the Administration has undertaken on behalf of the homeless. Information on both of these topics is provided in the attachments to this letter.

The amendments to the drug bill were very useful in focusing everyone's attention on the goal of ensuring that the needs of the homeless are taken into account in the operation of federally-funded programs. We share this goal with you and will be working diligently in the coming months to ensure it is achieved.

Sincerely yours,

James C. Miller III
Director

Attachments

ATTACHMENT I

THE 1988 BUDGET AND THE HOMELESS

The Federal Government funds entitlement programs for which the homeless may be eligible, programs specifically targeted to the homeless, and discretionary programs which can be used to help the homeless.

The FY 1988 Budget proposes no changes in individual entitlement program eligibility or benefit standards that would affect the homeless. Thus, these benefits will remain available to them. Although spending on the homeless from entitlement programs cannot be quantified, it probably constitutes the largest source of Federal support for the homeless. More of this population should receive benefits from entitlement programs as actions consistent with the spirit and letter of the drug bill amendments are taken.

The FY 1988 Budget also requests over $100 million in budget authority for programs specifically targeted to the homeless. This includes $80 million for FEMA's Emergency Food and Shelter program, $5 million for the Transitional Housing Demonstration program in HUD and an increase of $5 million (over 30 percent) for the community support program of demonstration grants in HHS' Alcohol, Drug Abuse and Mental Health Administration (ADAMHA). The additional ADAMHA funding will be used for demonstration projects targeted on mental health services for the homeless mentally ill. In addition, under our $2.2 billion generic request for social services activities, we would anticipate that the Runaway and Homeless Youth program would be funded at least at the enacted FY 1987 level of $23.3 million.

The FY 1988 Budget also proposes to establish a clearinghouse on the homeless in HHS. The clearinghouse, which will be funded at $250,000 a year in 1987 and 1988, will provide information and technical assistance to States and local communities interested in establishing or expanding shelters and other programs for the homeless. This information will not only be on Federal resources and programs, but also on State, local and private resources and programs and on federally-funded and other research which may benefit the homeless. The clearinghouse will build upon the work of the Interagency Task Force (discussed in Attachment II) and will free the Interagency staff to accelerate their efforts on behalf of the homeless.

Finally, the budget provides over $12.7 billion for discretionary programs that States and localities can draw upon to help the homeless, including the Community Development Block Grant, health, housing and other programs.

ATTACHMENT II

SELECTED FEDERAL INITIATIVES FOR THE HOMELESS

I. Interagency Task Force on the Homeless

The task force, composed of 15 Federal agencies and headed by HHS, coordinates Federal resources to help the homeless. The task force helps communities develop feasible strategies and educates them on Federal resources available to help the homeless. It has held workshops in all 10 HHS regions to inform regional homeless task forces about available Federal resources. The task force also enters into interagency agreements to support food and shelters operations and works with Federal agencies to remove impediments and cut red tape so that existing resources may be better used to serve the homeless.

A variety of activities have been carried out under the aegis of the task force. For example, the Department of Defense has obligated or spent $2.9 million to renovate surplus military facilities for use as homeless shelters. In addition, DOD and the General Services Administration have provided $3.5 million worth of surplus equipment to shelters at no cost.

II. Demonstrations for the Mentally Ill Homeless

HUD, in a joint effort with the Robert Wood Johnson Foundation and the Departments of Health and Human Services and Education, is conducting demonstrations for the chronically mentally ill homeless. HUD has committed approximately $100 million in Section 8 rental subsidies, which will be provided along with health and other services.

III. Homeless Veteran's Outreach Program

The VA has joined with veterans service organizations, the Department of Labor and SSA in a one year, 10 city model project to locate and train hard-to-reach homeless veterans. Workers hired through grants provided by DOL search under bridges, in vacant buildings and in other places to find these homeless veterans. Veterans are then individually walked through the system to ensure that they receive all the appropriate counseling, entitlements and job training from existing programs for which they are entitled. The ultimate goal is job placement.

BUDGET SUMMIT WITH PRESIDENT

We are going to conclude our hearings. I just want to note that we had all the Democrats here and the large majority of the Republicans were also in attendance. I think that demonstrates our interest Dr. Miller. I did not hear anyone here try to say that your budget was dead on arrival.

I have heard you claim people are saying that. I do not know who they are, unless they are the press or something. But here are the serious players in regard to the deficit and I did not hear it here.

But what I did hear, and I heard it from both sides of this oval here over and over, is the request that we get some kind of a meeting under the leadership of the President to really face up to the problems that we have and how we put this budget on track so that we can convince the American people that we are serious about it and so that we can begin to look at some of these other problems that have been raised by Senator Domenici and all of the members here, whether they have to do with some of our oppressing social problems that we know we are not meeting, and certainly they have to do with our problems in regard to economics, agriculture, trade, job promotion, education, all of those areas where we need to start this country moving again in a strong way, and the ability to compete again.

And so I hope that you will take that back to the President and see what we can do in that regard.

Dr. Miller. Mr. Chairman, could I say I am very grateful for this opportunity this morning, and very specifically grateful for the quality of the exchanges and the ideas and the suggestions and the mode of inquiry that has obtained this morning.

I do believe that it would be very useful for us to have further conversations before such a meeting with the President or whatever—I think some preliminary work would have to be done, but I think it would be useful on a bipartisan basis to explore things further, and I thank you.

Senator Domenici. Mr. Chairman?

Chairman Chiles. Yes, sir.

Senator Domenici. Could I just say to you I believe this has been an excellent beginning today, and I compliment you and the members on your side.

Chairman Chiles. It came from both sides.

Senator Domenici. Yes, but I mean from the standpoint of partisanship and this budget, I think there has been less effort to make the President's position one that is not sustainable than most times in the past.

Things are getting somewhat easier by way of the budget problem. Clearly, we are not there yet, but when you have a deficit between $150 billion and $165 billion and you are looking for $108 billion, it is a lot different from starting from $190 billion. The deficit is not going up dramatically; it is stabilizing somewhat.

TARGET BUDGET GROWTH RATE

It seems to me, Mr. Miller, that what we really ought to be looking at is the level of growth aside from mandatory entitlements that we cannot change. What is the level of growth that we ought to have for the next 3 or 4 years that would indeed move us in the direction of reaching the targets?

You see, I had a very good businessman look at this and he said, if your Federal budget grew at 1 percent a year for the next 3 or 4 years, you would be out of the woods.

Dr. MILLER. Yes, you would.

Senator DOMENICI. You would.

Dr. MILLER. Yes.

Senator DOMENICI. And what I am talking about is if we are going to one of these meetings where we talk about solving these problems, you all have to come up with some approach that would be enforceable and get us to agree that we would enforce it. Then we could fill in the gaps.

If you need more defense, then you have got to figure out a way to solve that problem, but clearly this thing is doable. When you look at how much can it grow, it can grow, but only a little bit for the next 2 or 3 years, and you may need new revenues.

I mean, you are talking about one-shot revenues, clearly, a lot of them; $22 billion worth of one-shot revenues. You do not want to call them taxes. That is all right; I mean, we understand. [Laughter.].

And they are not, I will admit. Only a small portion of them are, about 25 percent.

Chairman CHILES. About 25 percent.

PUT TEETH IN BUDGET CONTROL APPROACH

Senator DOMENICI. So it seems to me that we are in a position now where we have these targets that are thrust upon us. It seems to me they are the only way to make us really behave.

And I really believe we will come up with something up here together. But, frankly, I would hope that as we look at this, we look at some simple approach to this problem that has to do with Congress filling in some of the areas where it wants to trade in programs for something new.

That is what this President wants, I am sure.

Dr. MILLER. Yes.

Senator DOMENICI. He does not want to go with a new approach and find that it only lasts 12 months and then it has gone out the window. I think we can figure out a way to make it multiyear enforceable if we just have some exchange of ideas and some overall goals.

Chairman CHILES. Well, I have also suggested that I think we can certainly find a way to send any revenue with the spending cuts at the same time so that they all approach the President's desk at the same time.

Thank you very much.

Dr. MILLER. Thank you.

Chairman CHILES. We will recess our hearings until tomorrow morning.

[Whereupon, at 1:24 p.m., the committee was adjourned.]

ECONOMICS

THURSDAY, JANUARY 8, 1987

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:39 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Lawton Chiles (chairman of the committee) presiding.

Present: Senators Chiles, Sasser, Riegle, Exon, Lautenberg, Simon, Sanford, Wirth, Conrad, Dodd, Domenici, Symms, Kasten, Quayle, Nickles, and Rudman.

Staff present: Richard N. Brandon, staff director; John Hilley, assistant director for macro-economics, trade and finance.

For the minority: G. William Hoagland, staff director; and Gail Fosler, deputy staff director and chief economist.

OPENING STATEMENT OF CHAIRMAN CHILES

Chairman CHILES. Good morning. Secretary Baker, we welcome you to the Senate Budget Committee. Those who watch policy carefully have to give you a high mark for the steps you have taken to bring the dollar within realistic limits. It has been a bright spot of relief in these days when we have been so battered in the international marketplace.

REASSERT ECONOMIC POWER

Obviously, we are not out of the woods by any means. Our goal for both the near term and the long range is to reassert our economic power, and to do that we have to get ourselves in shape to compete.

We have tried some things in the past and they have not worked very well. We tried to negotiate away trade barriers on individual items. We seem to get nothing but excuses from other countries.

It seems to me that we have got to set bottom-line goals for American exports to other countries and let them work out the details, making it clear that if they cannot meet those goals we will have to limit their imports by a comparable amount. We have to expand our exports and organize our own approach to trade so that when our business people meet with foreign governments—a competitor who has the full backing of its government—our Government is not going to turn its back on our own business people.

We certainly need to chop the Federal deficit with a prudent budget plan that makes spending and revenues effective partners. And we need to make room for investments. We need to be more determined with solid trade initiatives. If we can get the deficits down, then we can maintain a competitive dollar, assure low interest rates, and get on with investment-led growth. So we need to be productive, and competitive, and bold.

ASSET SALES OFFER LITTLE LONG-TERM RELIEF

I am not sure that the administration's budget provides that total game plan we need. More than half the savings proposed in this budget come from revenues. A good portion of those revenues come from what you term, "asset sales."

Asset sales may reduce the deficit for a year, but the overriding goal is to eliminate the deficit over a 5-year period. Asset sales, I am afraid, are not much more than heat lightning in a dry spell. It is a quick flash of light but not much long-term relief.

It occurs to me that selling assets is a device that just puts off the key issue. How do we become more productive? How do we create new capital, rather than selling off our assets to pay for yesterday's and tomorrow's debts?

What we need in this budget is a well-constructed package where everyone is involved in the effort to reduce the deficits, to make investments, to restore competition, and to revitalize our productivity.

Those are all critical to the health of our economy and the job prospects of our workers. We have to make progress the new-fashioned way. We have got to earn it with fresh thinking and with boldness.

I do not think we can sit back and depend on foreign generosity or some invisible hand to determine our future. We need mind and muscle power focused on restoration of our economic power.

COMPETITION KEY TO SUCCESS

The President's budget this year belatedly comes to the conclusion that competition is the key to our success. But it only goes half way. It says "compete," but then it turns around and makes a 30-percent cut in education funding. To me, that is paying lipservice to competition. It is a disservice to a new generation of young people who are ready to move ahead in the Nation.

The President's budget includes the rhetoric of competition, but when you phase out vocational education, that does not sound like competition to me. When you propose full, multiyear funding for biomedical research, those are fine words. But when we look at the hard facts of the budget we find that there will actually be fewer research grants.

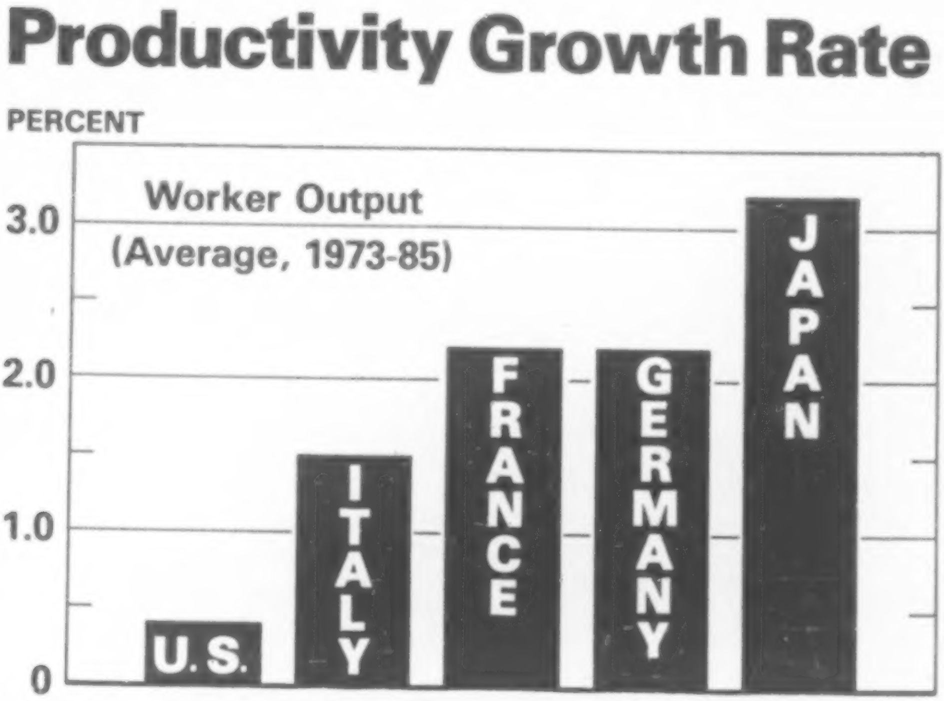
When there is no real increase for export promotion, that seems to send an unpleasant message about our willingness to compete. We cannot out-talk the competition. We have to out-work and out-produce them.

Nearly 80 years ago Herbert Croly wrote a book called "The Promise of American Life". In that book he said that the promise can be fulfilled, "not by conservative imitation of the past but by laborious, single-minded, clear-sighted, and fearless work." And he cautioned further that, "this better future will have to be planned and constructed rather than fulfilled of its own momentum."

I am afraid that we have been depending on momentum more than imagination, and more on imitating our past than planning for our future. Obviously, we have to do better and we have to reshape the budget so that it is singleminded and a clear-sighted document that will get us started.

U.S. PRODUCTIVITY PERFORMANCE POOR

To understand why, all you have to do is to look at that chart over there. Our productivity is one-eighth that of Japan, one-fifth—I say to my good friend from New Mexico—that of Italy.



Senator Domenici. I did not know the Italians did that well but——

Chairman Chiles. Well, it is just a pitiful performance for a world power like us. So the choices we make in the budget are critical and I think there are better choices to be made. Members on both sides of the aisle evidenced very much yesterday their willingness to sit down with the President anywhere, anytime to begin a bold exploration of our opportunities. They are there for the taking and the future is there for the making.

Senator Domenici.

OPENING STATEMENT OF SENATOR DOMENICI

Senator Domenici. Thank you very much, Mr. Chairman. What I really meant about the Italians——

Chairman Chiles. I hope you will not slur the Italians.

Senator Domenici. No; I thought that the ones here in America were doing well. [Laughter.]

I did not mean that any other way for all those we have here.

Well, let me say to you, Mr. Secretary, I am very pleased to join the Chairman in welcoming you here. You have been Secretary of the Treasury for less than 2 years and yet you have emerged as a real leader in economic policy and a real international figure for this administration on the international front. It is hard to believe that in that short period of time you have done as much as you have, and I commend you for it.

Obviously, today, Mr. Secretary, the focus of this hearing is the President's fiscal year 1988 budget. And clearly, as the distinguished chairman has been saying, you are concerned, as are all of us, not only about 1988, but about the future, knowing that there are some vagaries involved. We are concerned about a 3- or 4-year approach.

AGGRESSIVE TRADE POLICY HIGH ON PRIORITY LIST

You have emphasized the path toward international competitiveness and cooperation is intimately related to the budget issues which we will face over the next few months. The 1986 trade deficit is estimated to reach $160 billion, maybe a $170 billion. Many, particularly here in Congress, point to this as evidence that an aggressive trade policy, by way of changing our legislation, is very high on priority lists here in Congress.

I, for one, Mr. Secretary, believe that the trade deficit is a clear symptom of another problem; namely, continued sizable Federal budget deficits. I believe you concur. I hope you will comment on that. Budget deficit reduction is necessary for trade deficit reduction. The trade problem is a macroeconomic problem which, at the very least, requires a macroeconomic solution; namely, reducing the budget deficit of the United States.

It will be necessary to avoid another budget impasse in order to continue to make progress on the international front. The focus of today's hearing is the budget submitted by the President last Monday. It is our job in this committee and in the Congress as a whole to look closely at this document and use it to the extent we can as a starting point for Senate budget resolution preparation.

MODIFIED FREEZE WOULD HELP MEET GOAL

Deficit reduction is essential. I, for one, believe that it is well within our reach. As many of my colleagues here today know, and as you know, Mr. Secretary, I have been mulling over in my mind an idea which I call a modified freeze as an initial and long-term approach for meeting the Gramm-Rudman-Hollings goals. I believe I sent you some remarks with reference to that in the past 3 weeks.

This is a freeze on discretionary spending, defense and nondefense, but just the discretionary part of the budget. Looking at the new CBO numbers, a simple freeze in budget authority in all domestic appropriated programs, excluding pay, over the next 4 years, believe it or not, would bring us a long way toward meeting the goal, even that very difficult goal of a balanced budget under Gramm-Rudman-Hollings.

This is a sensible place to start. Nothing is ironclad and nothing makes sense in every instance. But to start, it seems to me it makes sense. I am again, as I told you, Mr. Secretary, talking about discretionary accounts only, because we have already gone down the path on social security and other aspects of this budget more times than many of us want to even think about.

Do I believe that we can go on with the same mix of programs frozen for 4 years? No, I do not. Obviously, we have inflation. But we also, obviously, have changing times.

In some cases we can go on with a freeze for 4 years. In others there has to be change. If an increase is necessary, I would hope we would challenge ourselves to get rid of some outmoded programs that have outlived their usefulness and then substitute the savings for those programs that need growth.

In some cases the need for new resources may just be too great; that case may be defense. Then, clearly, we need to raise revenues to pay for that kind of an increase. Even the President's budget would so provide.

This approach does not address in total the 1988 problem that is the most immediate one before us. But it does put us well on the way. We will need to accompany any plan with entitlement reforms, yes, and probably, even though you will be reluctant to agree, with some new taxes to assure that there is a balanced approach and that we reach the 1988 target and can reach the outyear targets.

For my part, Mr. Secretary, I am going to try my very best to work with the distinguished chairman and this committee. I hope you will work with us. I hope you will urge the President that he work with us. You have sent his budget up here. It is a starting point. It is our job now to decide which way we want to go.

Mr. Secretary, again, I am delighted that you are here and that you have accommodated us.

Mr. Chairman, I appreciate your giving me an opportunity to give my opening remarks.

Chairman **Chiles**. Thank you. Does anyone else have an opening statement?

[No response.]

Mr. Secretary, we will call on you.

STATEMENT OF HON. JAMES A. BAKER III, SECRETARY OF THE TREASURY

Secretary **Baker**. Thank you very much, Mr. Chairman, and thank you, Senator Domenici. Thank you both for those remarks.

Mr. Chairman, if it is all right with you I will just summarize my testimony and ask that the written testimony be submitted for the record.[1]

HISTORIC STEPS TAKEN

During 1986 I think the U.S. Government took two steps that could be characterized as historic that hold the promise of improving our economic performance for years to come.

First of all, the forces set in motion by the President in his state of the Union address 3 years ago culminated in the Congress. enactment of historic, comprehensive reform of our tax system. This bipartisan effort created a fairer, more equitable tax system, and it created one containing major incentives for increased economic progress.

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[1] See p. 98.

Secondly, the Tokyo Economic Summit laid the foundation for sustained world economic growth by starting to provide procedures for the improved coordination of economic policies among the seven major industrialized democracies. While the art of international economic cooperation could be said to be still developing, I think that some preliminary successes here have created for us an environment of opportunity.

The record for the year 1986 was generally favorable, although we do aspire for continued improvement. Let me briefly summarize.

EXPANSION SHOULD CONTINUE

The current expansion has now extended into its fifth year and I think most would agree that there is every prospect that this expansion will continue unabated through 1987 and into the years beyond.

In 1986 consumer prices increased less than in any year in more than two decades. Over the past 6 years inflation has been cut drastically from nearly 13 percent average in 1979 and 1980 to 4 percent or less for the last 5 years.

The number of people holding jobs increased by 2¼ million during the first 11 months of this year alone. Throughout the present expansion the number of jobholders has risen by more than 11 million, lifting the percentage of the civilian population which is employed to a record level of almost 61 percent.

Interest rates, of course, continued to decline. The prime rate is down 2 full percentage points from early January 1986. That is two-thirds of what it was in 1981, and at 7.5 percent it is the lowest that we have seen in more than 9 years.

So, Mr. Chairman, I would submit to you that this is solid economic performance. I do not for 1 minute, however, suggest that we do not have some problems or that we do not have significant work still to do. But this progress of 1986 should set the stage for an even better year for real economic growth and employment in 1987.

ECONOMY GAINING SOME MOMENTUM

To summarize our economic forecast, we expect real growth to average 3¼ percent across the four quarters of this year. This estimate is roughly in line with the private forecasters. consensus of growth close to 3 percent, and I hope that there are not going to be suggestions this year that somehow we are adopting a rosy scenario forecast, because we do not think that we are. It is a little faster than the roughly 2.5 percent average during the first three quarters of 1986, but signs were emerging in the last part of last year that the economy may be gaining some momentum.

We cannot expect inflation to remain as moderate as in 1987 as in 1986, which benefitted, of course, from the fall in world oil prices. Still, there is no resurgence of inflation in prospect and we expect the GNP deflator to increase by about 3.5 percent during the year, with consumer prices rising perhaps a shade more than that.

Developments in the world economy should also help to further our objectives in 1987. We have, and as you mentioned, I think, Senator Domenici, in your comments, been working closely with the leadership of the major industrialized nations to improve economic policy coordination and to improve the global prospects for sustained noninflationary growth.

We expect to continue to impress upon foreign industrial countries, particularly those with large surpluses, our mutual need for them to achieve stronger, sustained growth. Because it is clearly time for our exporters to benefit from the greater growth abroad and a more reasonably valued dollar, we could not, as a nation, pick a worse time to unfurl the banner of protectionism.

SUSTAINED GROWTH FOR DEBT-BURDENED DEVELOPING COUNTRIES

Our program for sustained growth for debt-burdened developing countries also is coming into place, enhancing prospects of renewed growth and development in these countries. These debt problems did not occur overnight and they are not going to be solved overnight.

But the combination of market-oriented economic reforms, structural lending from the multilateral institutions, and commercial bank loans to help implement comprehensive adjustment, I think, is making a very good start.

The growth-oriented reforms undertaken by the debtors are critical to the success of our debt initiatives. They deserve our support, and the multilateral development banks are a particularly important vehicle for promoting them.

We and other member countries have succeeded in persuading the MDBs to advocate financing in support of these difficult but much needed structural and sectoral reforms. The United States clearly has significant influence in these multilateral development banks, but this influence will diminish if we are not able to fulfill our commitments to these institutions. Consequently, I think it is essential that Congress support the U.S. contribution which is reflected in this budget.

FURTHER REDUCTION OF FISCAL DEFICIT

We have come a long way over the past 6 years, but there is still at least one, and probably more, but at least one major item of unfinished business. You alluded to it, Mr. Chairman, and it is further reduction of the fiscal deficit.

I happen to think we have reached a turning point on the deficit, and I heard Senator Domenici, somewhat to my surprise, say the same thing at a conference on debt and trade in New York late last year.

Measures already taken, I think, have pointed us in the direction of reduced deficits through spending restraints. Even if one assumes pessimistic economic forecasts, I think it is fair to say that the administration and the Congress working together have put in place reforms that should lower the 1986 fiscal year deficit of $221 billion to roughly $175 billion, at least, in fiscal year 1987; in other words, from about 5.3 percent of GNP to about 3.9 percent, with further reductions in later years.

Even this substantial reduction can be improved upon. The President's budget provides a plan for further substantial progress. If the proposals in this budget are adopted, the deficit would shrink substantially for the second consecutive year, and would drop to about 2.3 percent of GNP in fiscal 1988.

The deficit, in our view, should be cut by reducing the scope of Government rather than through tax rate increases. We do not think the American people are undertaxed. Revenues, as a share of GNP projected over the next 6 years, are about 1 full percentage point above the historical average for the period 1964 to 1979. In contrast, the outlay share of GNP in the past 2 fiscal years was about 4 percentage points above the historical average.

LESS RELIANCE OF PROGRAMMATIC REDUCTIONS

We've approached deficit reduction somewhat differently in this budget this year. There is less reliance on programmatic reductions, and we are not relying as heavily on spending cuts previously submitted and rejected by the Congress. We are proposing $18.7 billion in deficit reduction on the spending side in fiscal 1988. We are also recommending $22.4 billion in deficit reduction in fiscal 1988 through changes which affect receipts. Of this amount, about $13 billion represents proceeds from loan asset sales, from privatization efforts, from credit reform, and from proposals to strengthen the FSLIC.

Unlike new taxes, these proposals do not represent a permanent revenue strain which would encourage the growth of government and a larger Federal establishment. And while the remainder of the receipt changes do represent permanent revenue proposals, they have to do with initiatives to collect taxes owed or fees for services. These revenue measures should be distinguished from a general tax increase that could be used to support additional spending.

COMPETITIVE CHALLENGES MUST BE MET

Let me comment on one final area. There is, I think, a growing recognition that the United States faces new competitive challenges in the world economy. We have to meet these challenges if we are to maintain our economic strength and if we are to maintain our world leadership.

The administration will continue to promote a more efficient use of resources that can improve competitiveness. We should defend intellectual property rights at home and in international negotiations, and we should remove legal barriers to the international competitiveness of United States industry in the areas of antitrust and product liability.

In addition, the administration's budget seeks to strengthen certain "leading-edge" technologies by fostering the commercial development of space and strengthening military programs involving strategic computing and very high-speed integrated circuits.

Efforts to promote human capital development are also important for improving productivity and in improving competitiveness. Accordingly, the budget includes funds to expand and improve training and job placement assistance for workers dislocated due to imports or other developments.

Fundamental to good governments is the ability to set priorities. This budget shows that eliminating the deficit is possible and it is possible without raising taxes, without sacrificing our defense preparedness, or without cutting into the safety net for the poor and the elderly.

NATIONAL INTEREST PROGRAMS SHOULD BE FUNDED

Other programs basic to our national interest also should be properly funded. Some, like basic scientific research in the space program, will help keep America strong as we prepare for the 21st century. Others, like drug enforcement, AIDS research, and reduction of infant mortality, will safeguard the soul of America, her people.

This budget can help prepare America for the future while moving us well along the deficit reduction path. I recognize that any venture involving budget-cutting will breed disagreements, some very, very strongly held. But we have to keep at it, and I know you agree.

Now that we have turned the corner we cannot slacken. The Congress has taken some very, very difficult votes on expenditure cuts over these past years. We recognize and we applaud those members of both parties who have acted courageously to better serve the Nation's interest. We are hopeful that their leadership will carry forward the momentum of deficit reduction.

Thank you very much, Mr. Chairman.

Chairman CHILES. Thank you, sir.

[The prepared statement of Secretary Baker follows:]

Testimony of the Honorable James A. Baker, III
Secretary of the Treasury
Before the
Senate Budget Committee
January 8, 1987

Mr. Chairman and Members of the Committee:

It is a pleasure to meet with you today to discuss the state of the economy, the Administration's Budget, and our proposals for deficit reduction.

1986 in Review

During 1986, the United States Government took two historic steps that hold the promise of improving American economic performance for years to come.

First, the forces set in motion by the President in his State of the Union Address of three years ago culminated in Congress' enactment last summer of a comprehensive reform of our tax system. This bipartisan effort created a fairer, more equitable tax system -- one which enhances economic efficiency and strengthens incentives for increased economic progress. Tax reform should remove about 6 million Americans from our income tax rolls. It slashes the top statutory individual tax rate to less than half the top rate when President Reagan took office. And it focuses capital on productive uses, not tax uses.

Second, the Tokyo Summit laid the foundation for sustained world economic growth by starting to provide procedures for improved coordination of economic policies among the seven leading industrial democracies. While the art of international economic cooperation is still developing, our preliminary successes have created an environment of opportunity.

The record for the year 1986 was generally favorable -- though we aspire for continued improvement. To summarize briefly:

- The current expansion has extended into its fifth year, exceeding in duration 5 of the previous 7 expansions. There is every prospect that the current expansion will continue unabated through 1987 and the years beyond. Despite the longevity of this expansion, it has led to few if any of the imbalances that marked the latter stages of previous cyclical expansions.

- The increase in consumer prices during 1986 was less than in any year in more than two decades. For the millions of elderly Americans who fear the erosion of hard-earned savings from inflation, this affirmation of our earlier accomplishment is most welcome. Over the past six years, inflation has been cut drastically from the nearly 13 percent averaged in 1979 and 1980 to 4 percent or less for the last five years.

- The number of persons holding jobs increased by 2-1/4 million during the first eleven months of the year alone. Throughout the present expansion the number of jobholders has risen by more than 11 million -- lifting the percentage employed of the civilian population to the record level of 60.9 percent.

- Interest rates continued to decline. The prime rate is down 2 full percentage points from early January 1986 (down two-thirds of what it was in early 1981), and at 7-1/2 percent is the lowest in more than nine years. Other rates, both short- and long-term, are down 1-1/2 percentage points from a year ago. This has been particularly good news for young people striving to buy their first homes or refinancing high rate mortgages. Policies of the Federal Reserve assured that ample credit was available.

I would submit to you that this is a solid economic performance. Nevertheless, we still have much work to do. The progress of 1986 should set the stage for an even better year for real economic growth and employment in 1987.

1987 Forecast

To summarize our economic forecast, we expect real growth to average 3-1/4 percent across the four quarters of this year. This estimate is about in line with the private forecasters' consensus of growth close to 3 percent. It is a little faster than the roughly 2-1/2 percent averaged during the first three quarters of 1986, but signs were emerging in the latter part of last year that the economy may be gaining momentum.

We cannot expect inflation to remain quite so moderate in 1987 as in 1986, which benefited from the fall in world oil prices. Still, no resurgence of inflation is in prospect, and we expect the GNP deflator to increase by about 3-1/2 percent across the four quarters of the year, with consumer prices rising by a shade more than that.

For the longer term, it is reasonable to expect the economy to grow at least a little above trend until a fuller rate of resource utilization has been reached, and that is incorporated into our forecast. Our longer-term forecast also envisions that we will maintain and improve upon our progress in bringing down the rate of inflation.

International Economic Outlook

Developments in the world economy should also help to further our objectives in 1987. Since the Tokyo Summit last May, we have been working closely with the leadership of the major industrialized nations to refine the techniques of economic policy coordination. In October, the United States and Japan announced agreement on cooperative bilateral actions to contribute to sustained growth of the international economy. We need to build on our successes while recognizing that each meeting will not produce an agreement and each agreement cannot result in a major redirection of economic trends.

Domestic sources of demand growth abroad strengthened last year, particularly in Europe. Together with a further orderly decline of the dollar, this helped to stem the deterioration in our trade balance. Over the past year our trade deficit has roughly flattened out, and we expect a significantly lower deficit in 1987.

We will continue to impress upon foreign industrial countries, particularly those with large surpluses, our mutual need for them to achieve stronger, sustained growth. Because it is clearly time for our exporters to benefit from greater growth abroad and a more reasonably valued dollar, we could not pick a worse time to unfurl a banner of protectionism.

International Debt

This Committee is well aware of the myriad linkages between debt and trade, as well as their common connection to global growth and financial stability. We all have a stake in constructively addressing international debt difficulties -- not via quick-fix gimmicks, but through lasting solutions to underlying problems.

I recognize that it is politically tempting to search for dramatic gestures which could sharply reduce debt service burdens overnight, or significantly increase the financial resources available to debtor nations to import our goods. Across-the-board debt forgiveness, in this light, may have some appeal, but would ultimately damage both debtor nations and the global economy. External capital would be available to debtors at prohibitive prices, if at all; bank losses would further weaken our most important financial institutions; and U.S. budget and taxpayer costs would increase significantly.

Similarly, calling for massive new lending (by others) to the debtor nations, either bilaterally or through a new multilateral fund, may appear to offer an easy way to boost U.S. exports and growth in the debtor nations. But without fundamental policy reforms, neither U.S. exports nor debtor growth can be sustained for the longer term. Throwing money at the debtor nations won't solve their problems; it will, in fact, worsen their difficulties unless the new financing can be productively absorbed and is consistent with their ability to grow and service debt.

In contrast to these "overnight" solutions, the strengthened debt strategy focuses on improving the debtors' growth potential through both macroeconomic and structural reforms, supported by modest new financing essential to meet immediate needs. Despite the relatively short period which has passed since the debt initiative was proposed, considerable progress has been made.

- Many debtors are already taking important steps toward increasing savings and investment, improving their economic efficiency, privatizing public enterprises, and encouraging the return of flight capital.

- The IMF has established new standby programs with 7 of the 15 major debtors since October 1985, including new loan commitments of about $3.1 billion.

- The World Bank has negotiated $3.7 billion in new policy-based loans with 10 major debtors, and has discussions underway on an additional $4.7 billion in such loans. Aggregate World Bank loan commitments to these debtors increased by 40 percent during its Fiscal Year 1986, and a substantially larger share of loans are now based on structural policy reforms.

- Finally, the commercial banks are also moving to make new loans available, as exemplified by the recent $7.7 billion package for Mexico, a $320 million new money package for Nigeria, and a $220 million oil facility for Ecuador.

Nearly $70 billion in debt reschedulings have been negotiated with the major debtors since October 1985. A number of other financing packages and reschedulings are also now under discussion.

Externally, interest rates have been reduced by nearly 5 percentage points since 1984, saving the major debtors over $13 billion in interest payments annually. Efforts are underway to achieve stronger growth in other industrial nations, and to open global markets through the new multilateral trade negotiations.

This is a start -- a good one. We hope for further progress, but realistically must recognize that it will be gradual and will vary among nations, depending upon their own determination to implement growth-oriented reforms and the continued active support of the international community. That is the task before us, and the only true solution to international debt problems.

The MDBs are a particularly important vehicle for promoting growth-oriented reforms and for furthering U.S. foreign policy objectives. We, and other member countries, have succeeded in persuading the MDBs to advocate financing in support of difficult, but much-needed structural and sectoral growth-oriented reforms which are a central element of the debt strategy.

We have also succeeded in convincing other donor countries to increase their support of the MDBs. For instance, the Japanese increased their contribution to the eighth replenishment of IDA by $450 million over and above their normal proportion, and the United Kingdom, the West Germans and other European countries made additional special contributions to IDA. In total these increased contributions result in an IDA VIII of nearly $12.5 billion and a U.S. share of 23 percent, which is 2 percent less than the 25 percent U.S. share negotiated for IDA VII.

The United States clearly has significant influence in the MDBs. However, U.S. influence will diminish if we are not able to fulfill our commitments to these institutions. Consequently, it is essential that Congress support the Administration's FY 1987 supplemental request of $293 million and our FY 1988 request of $1.8 billion.

In a period of tight budgets, the cost effectiveness of the MDBs should also be recognized: one dollar of U.S. budgetary authority for the World Bank translates into $60 of World Bank lending authority. About 90 percent of MDB lending also supports countries of importance to the United States, some of which receive little or no U.S. foreign assistance, such as Mexico and Argentina.

Budget and Deficit Overview

We have come a long way over the past six years. Still, there is a major item of unfinished business on the fiscal agenda -- further reduction of the Federal budget deficit.

We have reached a turning point on the deficit. Measures already taken have pointed us in the direction of reduced deficits through spending restraint. Even if one assumes pessimistic economic forecasts, we already have put in place reforms that should lower the 1986 Fiscal Year deficit of $221 billion to roughly $175 billion in Fiscal Year 1987 on a current services basis -- from 5.3 percent of GNP to 3.9 percent -- with further reductions in later years.

Even this substantial reduction can and should be improved upon. The President's Budget provides a plan for further substantial progress. If the proposals in the Budget are adopted, the deficit would shrink substantially for the second consecutive year and would drop to about 2.3 percent of GNP in Fiscal Year 1988. When it passed the Gramm-Rudman-Hollings Act, the Congress set a deficit target of $108 billion for Fiscal Year 1988. We are submitting a budget that hits this target without raising taxes.

The deficit should be reduced by reducing the scope of government, rather than through tax rate increase. The American people are not undertaxed. As shown by the first chart attached to my statement, revenues as a share of GNP projected over the next six years are about one full percentage point above the historical average for the period 1964 to 1979. In contrast, the outlay share of GNP in the past two fiscal years was about four percentage points above the historical average.

Our budget cuts the growth in spending. Outlays will continue to grow in absolute terms along the path projected in the new budget, but the rate of advance will be reduced significantly. Between FY 1986 and FY 1992, nominal Federal outlays would rise on average about 3 percent per year. In the prior six-year period, 1980-1986, the rate of growth was about 9 percent per year. Along the path projected in the new budget, Federal outlays would decline steadily as a ratio to GNP from just under 24 percent in 1986 to just over 19 percent in 1992.

Receipts will be growing strongly in absolute terms as the economy itself grows, and as previously scheduled payroll tax increases become effective in 1988 and 1990. Receipts are projected to rise by an average of 7.6 percent annually between FY 1986 and FY 1992, close to the 8 percent rise averaged in the previous six-year period. Receipts as a share of GNP will rise from 18.5 percent in 1986 to 19.4 percent in 1991 and 1992.

A number of other turning points are projected in the FY 1988 Budget. These turning points are important for the stability of the credit markets and continuation of low interest rates and economic expansion. As the second attached chart shows, beginning in FY 1987, interest payments on the debt will be falling as a share of the budget, permitting faster growth in other outlay categories. As the third attached chart shows, by FY 1988, the economy will be growing faster than the national debt. By FY 1990, the national debt will be rising less rapidly than the rate of inflation, and will actually be falling in real terms.

Fundamental to good governance is the ability to set priorities. This budget shows that eliminating the deficit is possible without raising taxes, without sacrificing our defense preparedness, and without cutting into the safety net for the poor and elderly.

Other programs basic to our national interest also should be properly funded. Some -- like basic scientific research and the space program -- will help keep America strong as we prepare for the 21st Century. Others -- like drug enforcement, AIDS research, and reduction of infant mortality -- will safeguard the soul of America, her people.

Approach to Deficit Reduction

We have approached deficit reduction somewhat differently this year. There is less reliance on programmatic reductions, and we are not relying substantially on spending cuts previously submitted and rejected by Congress. We are proposing $18.7 billion in deficit reduction through cuts in programmatic spending in FY 1988. This is consistent with our goal of a permanently lower level of Federal spending, gradually arrived at.

We are also recommending $22.4 billion in deficit reduction in FY 1988 through changes affecting receipts. Of this amount, about $13 billion represents proceeds from loan asset sales, privatization efforts, credit reform and proposals to strengthen the FSLIC. These proposals provide a variety of near term budget savings over the next few years. Unlike new taxes, these proposals do not represent a permanent revenue stream which would encourage growth of government and a larger Federal establishment. Indeed, they work in the opposite direction.

The asset sales and privatization initiatives are one-shot final sales of portfolios and assets which are better managed and better run by the private sector. Sale of these assets will reduce the intrusion of the Federal Government into the economy. (Of course, there will be ongoing tax revenues received from profitable privatized enterprises.) Credit reform, while a permanent program, would act to reveal unintended subsidies and de facto "grants" on questionable or defaulted loans. While saving money near term, it would act to slow the growth of such programs and reduce government involvement in credit allocation decisions better left to the market. FSLIC recapitalization mobilizes the future insurance fees charged to the S&L industry to hasten the resolution of problems facing a portion of the industry, saving money long term and speeding the day when FSLIC intervention will return to more normal levels.

While the remainder of the receipts changes do represent permanent revenue proposals they have to do with equity or fees for services, which must be distinguished from a general tax increase. For example, the IRS initiative seeks to improve on the collection of taxes owed but not paid. The extension of the medicare HI tax to state and local workers will cover a group whose members often become eligible for medicare services as spouses of eligible retirees or through periods of covered earnings in other occupations. Customs user fees are obviously fees for service.

The reduced level of debt brought about by these programmatic and receipts proposals will result in a reduction in interest outlays of $1.3 billion in FY 1988, in addition to the savings listed above.

In brief, we feel that these proposals are an innovative solution to the problem of reducing the deficit without expanding the government, and that they enhance both equity and economic efficiency at the same time. They offer added budget savings in the short term to achieve the desired degree of deficit reduction while enabling us to approach longer term programmatic savings in a more orderly and gradual fashion. This will make it easier ultimately to accomplish more in the way of permanent deficit reduction via reduction in the size of government.

Receipts Proposals in the Budget

Asset Sales -- To preserve individual initiative and limit state interference, governments should restrict the type of goods and services they supply to those that are not provided by the private marketplace. In the past, the Federal Government has not always followed this policy and has acquired many commercial-type assets, real and financial, that in effect make the government a direct competitor of the private sector. In his FY 1987 Budget, the President proposed that we start selling off some of these assets. We have renewed this proposal in our FY 1988 Budget.

Asset sales have both positive and negative accounting effects on the budget, depending on the time perspective. In the short run the overall budget deficit will be reduced by the net amount received from the purchasers of the assets. Budget deficits in later years will increase, however, because the sale of an asset today means that the government will not receive in later years the expected stream of income from the sale of goods and services produced by the physical assets or the interest income and principal repayments on financial assets that it otherwise would have received.

A significant part of the asset sales recommended in the FY 1988 Budget are sales of loans. By selling a portion of its loan portfolio to private investors the government can reduce its expenses incurred in administering these loans. In addition, loan sales at market prices provide a measure of the subsidy provided to the borrowers. This subsidy can be compared with the social and economic benefits of the loan. And it provides the Executive Agencies and the Congress with the information necessary to compare the relative costs and benefits of the subsidized loans.

The FY 1988 Budget proposal for loan sales includes loans with a face value of $11.2 billion in 1988, producing net revenues of $5.3 billion.

In addition to its existing loan portfolio, the Federal Government currently provides new direct loans and loan guarantees through various credit programs. In keeping with the objective of not competing with the private sector, Federal credit programs should operate through the private markets and reveal their true costs. Toward this end, the President is proposing to change the way Federal credit programs are treated in the budget. These changes, which will provide revenues of $1.3 billion in FY 1988, will provide a measure of the value of subsidies granted under Federal credit programs, give the Administration and the Congress better analytic tools to evaluate the allocation of Federal resources among programs, and put direct loans and loan guarantees on the same footing as other full cost Federal expenditure programs.

User Fees -- The President's Budget continues to emphasize the importance of assuring that those who receive and benefit from special Federal services bear the cost of those services, rather than the general taxpayer. Instead of providing these services to special groups free of charge or below cost, those who benefit from special Federal services should be required to pay user fees or other charges that reflect the cost of providing these services. Accordingly, the Budget imposes additional fees and charges of $3.2 billion for such services as VA, FHA and GNMA home lending activities, Coast Guard services, recreation user fees, travel fees, and a new insurance fee on guaranteed student loans to cover the costs of loan defaults.

Privatization -- The Administration's strategy of shifting the production of goods and services from the public to the private sector is consistent with a policy of not competing with the private marketplace, reducing government spending, and maximizing economic efficiency. Budget proposals include the sale of ongoing businesses and productive assets to the private sector, reduction of legal barriers to competition, and contracting out for the provision of commercially-produced goods and services.

The FY 1988 Budget estimates include $5.4 billion of additional revenue from such privatization initiatives as divesting Amtrak; sale of the Naval Petroleum Reserves, and helium operations; and auctioning off licenses for the unassigned radio spectrum for non-mass media services.

Other enforcement and revenue initiatives -- The Budget includes several other enforcement and revenue initiatives that will increase FY 1988 receipts. These initiatives are limited to measures that will help collect taxes owed but not paid and that affect the financial condition of certain government trust funds.

In total, these revenue initiatives amount to $6.1 billion in FY 1988 and include such items as better IRS enforcement of the tax laws, extending the medicare hospital insurance payroll tax to state and local government employees, repealing exemptions from gasoline and other highway excise taxes, and broadening and extending beyond their expiration date certain Customs user fees.

Finally, another initiative to help reduce the budget deficit concerns the problem of our failing thrift institutions. A proposal to recapitalize the Federal Savings and Loan Insurance Corporation was sent to the Congress last year. During the closing weeks of the last session of Congress, the House and Senate passed basically the same version of a bill addressing this problem, but compromise legislation was not sent to the President. The Treasury considers this very necessary legislation, and we hope the 100th Congress acts on it promptly. This proposal would raise $1.6 billion in FY 1988.

American Competitiveness

There is growing recognition that the United States faces new competitive challenges as a result of fundamental changes in the world economy. Many countries have emphasized scientific progress, technology transfer and improved productivity growth to strengthen the international competitiveness of their economies. The United States must meet these competitive challenges to maintain its economic strength and world leadership.

Concern for global competitiveness does not necessarily imply that we should look at policies that will artificially promote certain industries or sectors to reduce specific portions of our trade deficit. Such an approach suggests an industrial policy that could emphasize some industries that do not have a comparative advantage in trade at the expense of those that do, and could impede the efficient allocation of our resources.

Rather, there are several areas where Federal Government actions, in the context of a free market and limited public involvement, could increase overall U.S. productivity and improve U.S. competitiveness by promoting more efficient use of resources. These include encouragement of research and development, defense of intellectual property rights at home and in international negotiations, promotion of human capital development, and removal of legal barriers to the international competitiveness of U.S. industry in the areas of antitrust and product liability. The Administration has already taken a number of steps in these areas which we will continue to pursue in the next two years.

In addition, we propose several programmatic increases in the FY 1988 Budget. These proposals include increased funding for Federally supported basic research. The Budget would increase funding about 18 percent for basic research for the National Science Foundation, and double its research budget over the next 5 years; increase funding about 22 percent for basic research by NASA, including two new science and technology programs; and increase funding about 15 percent for the general science programs of the Department of Energy.

Basic research on an interdisciplinary basis often leads to creation of important new fields, such as biotechnology. For 1988, the Administration proposes to establish 5 to 10 new interdisciplinary science and technology centers through the National Science Foundation, modeled after NSF's existing engineering research centers, with participation by industry and the states to speed transfer of new knowledge from the laboratory to the marketplace. In addition, the Administration proposes to increase the emphasis on academic basic research programs in order to enhance the development of the nation's scientific and engineering human capital.

A substantial amount of non-classified technology and new knowledge is developed in Federal laboratories. However, its usefulness is limited if it is not made available to the private sector where it can contribute to creation of new products, new processes, new jobs and enhanced U.S. competitiveness. Using the Technology Transfer Act of 1986 and other authority, the Administration will increase efforts to transfer to the private sector results of Federally supported research and development through greater use of incentives for Federal scientists and engineers, exchange of scientists and engineers between government laboratories and industry, and cooperative research projects between industry and Federal laboratories.

The Administration's Budget also seeks to strengthen certain "leading edge" technologies. We propose to: initiate a new civil space technology effort to deploy the space station, develop the national aerospace plane, and foster commercial development of space; strengthen the Strategic Defense Initiative and associated Department of Defense initiatives involving strategic computing and very high speed integrated circuits; and support cooperative research and development ventures by the Department of Energy to encourage greater private sector participation in fossil, solar, and energy conservation research and development.

Efforts to promote human capital development are also important for improving productivity and competitiveness. Accordingly, the Budget includes funds to expand and improve training and job placement assistance for workers dislocated due to imports or other developments.

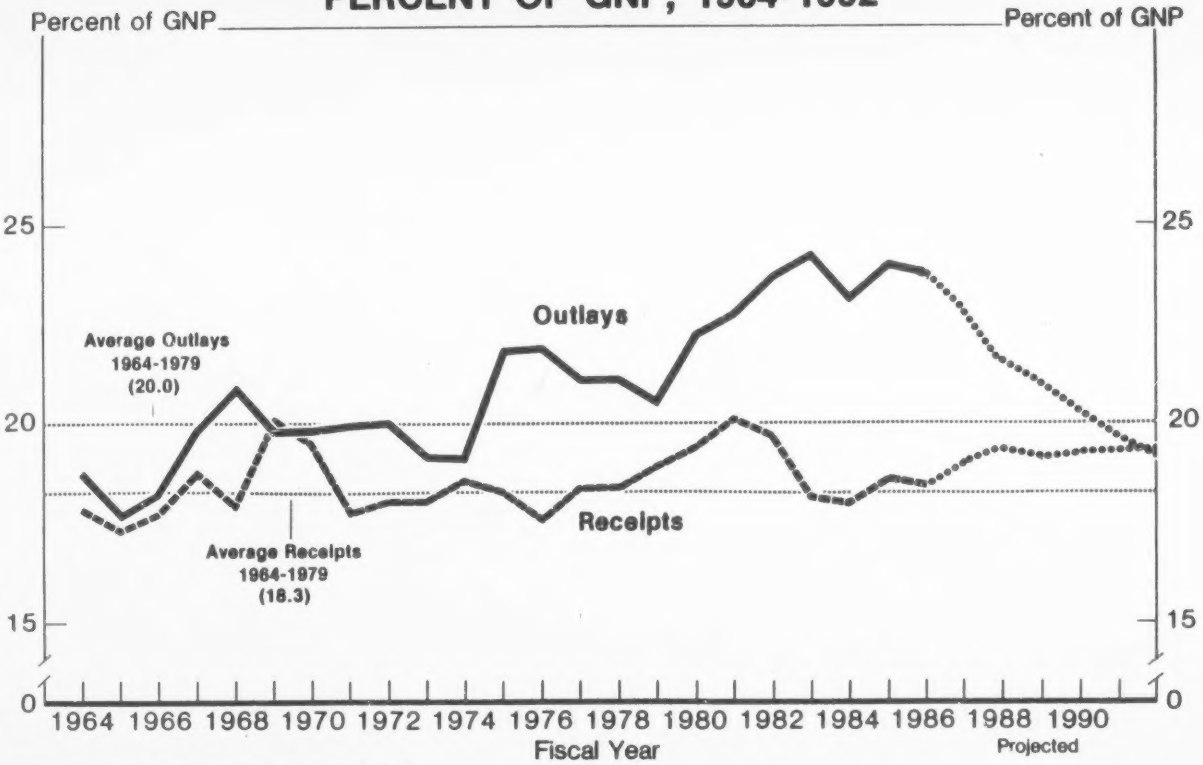
Conclusion

The President's Fiscal Year 1988 Budget can help prepare America for the future, while moving us well along the deficit reduction path. I recognize that any venture involving budget cutting will breed disagreements -- some very strongly held. But we must keep at it. Now that we've turned the corner, we can't slacken our efforts and our determination to reduce the deficit.

Congress has taken some difficult votes on expenditure cuts over these past years. We recognize and applaud those members, of both parties, who have acted courageously to better serve the nation's interest. We are hopeful their leadership will carry forward the momentum of deficit reduction.

Attachments

OUTLAYS AND RECEIPTS AS PERCENT OF GNP, 1964-1992



Note: Outlays include off-budget federal entities.

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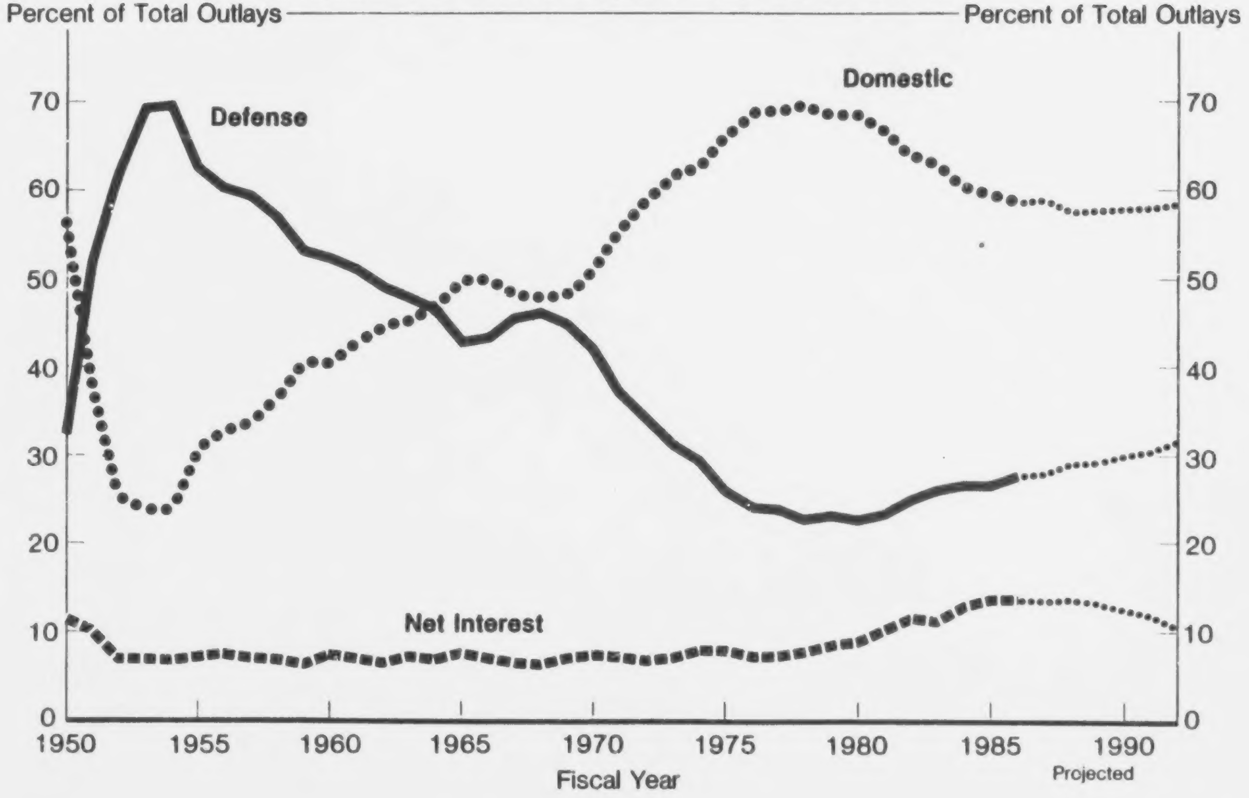
SHARES OF TOTAL BUDGET OUTLAYS



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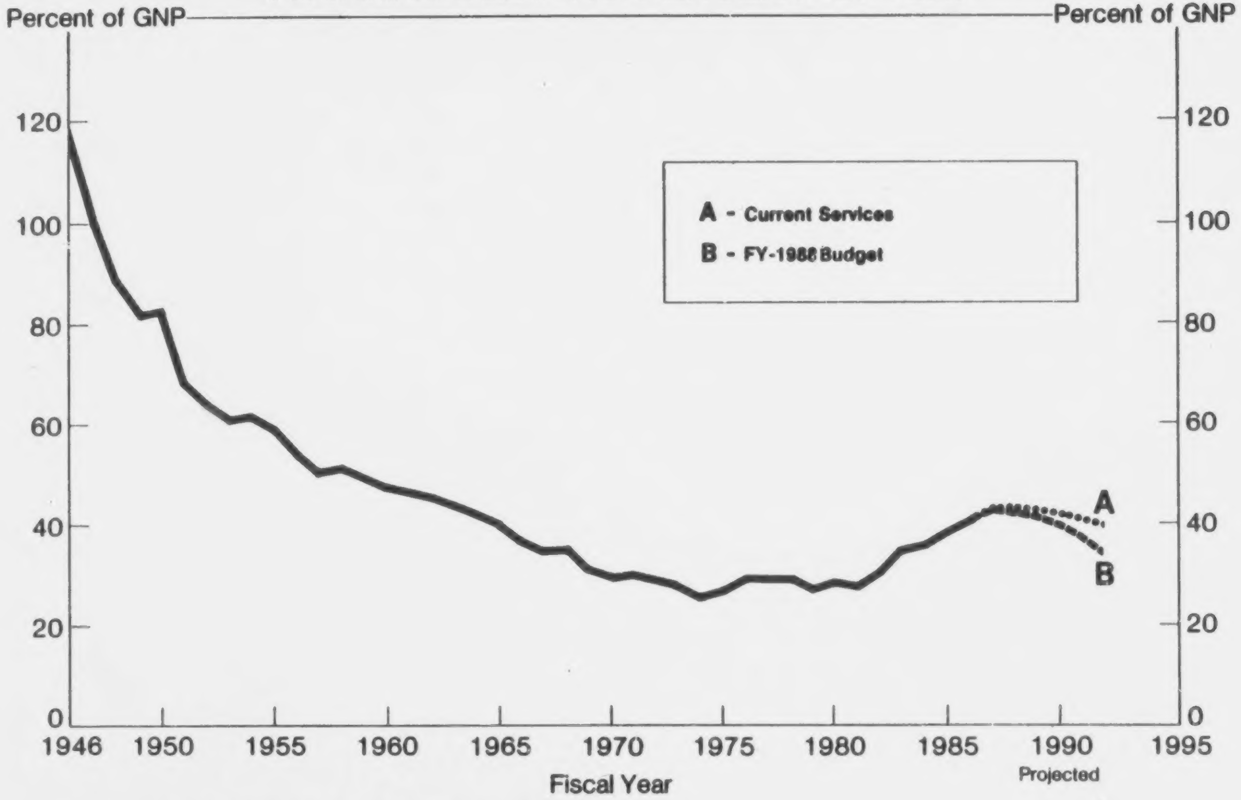
FEDERAL DEBT AS PERCENT OF GNP



Note: Debt held by the public, including the Federal Reserve.

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Chairman **Chiles**. We will begin with Senator Conrad.

ROSY ECONOMIC FORECAST ADOPTED

Senator **Conrad**. Thank you, Mr. Chairman. Mr. Secretary, you would have a hard time convincing the people of my State that there has been a solid economic performance last year. As you know, my State, among others in the farm belt, has been very hard hit. And I must say, I am puzzled when I hear us talk about solid economic performance. In the last 6 years the national debt has doubled, the trade deficit has gone up sixfold. During the most recent month we hit $19 billion on the trade deficit and, in a recent 3-month period, we imported more agricultural production than we exported for the first time in anyone's memory.

I am very, very concerned that we are on a path that puts America at a serious disadvantage internationally and is very harmful to the productive sector. And still the administration comes forward with a budget plan that has at least $108 billion of deficit. And frankly, I think many observers would say it is much more than that, that you have adopted a rosy economic forecast, as you certainly did last year—very rosy compared to what has actually developed.

I would like to know how you explain the reasons that the economic game plan has gone off the track and what could be done, in a serious way, to get this economy back on track in the productive sector?

Secretary **Baker**. Well Senator, I think the fact that we have had what I consider to be good performance economically as a nation overall does not argue for 1 minute that we do not have some sectors of our economy that are very, very hard hit and that are in big trouble. You mention your State and I will mention mine. The same thing, quite frankly, is true in my State, as in the agricultural sector which across this Nation has been very hard hit.

MOVE TO FREE-MARKET ECONOMY BASE

I happen to believe that the answer to problems in agriculture is not for us to continue to direct more taxpayer dollars or more consumer dollars toward that sector, but it is to find some way to get that sector back to a free-market economy base, move it more to a free-market economy basis, if you will. We do have problems with the trade deficit. We do have problems with the fiscal deficit. And my statement, I hope, acknowledged that, and if it did not, I do acknowledge it. I think those are the two biggest problems facing the country. We have got an energy sector that has very difficult problems.

Some of these sectoral problems are the consequence of our having conquered inflation, quite frankly. There were many people who were betting on inflation because we had to live with it for so very, very long. And there were people, if I may say so, or suggest so, probably in your State, betting that land prices were going to continue to keep going out of sight. And I know there were people in my State that were betting that. But it has been extremely good for the Nation as a whole that we have gotten inflation under control.

So what do we need to do? We need to become more competitive, we need to continue to work hard to bring this fiscal deficit down, but we need to do it in a way that will not harm the economy. We need to do it in a way other than raising taxes, if I might suggest. And we have submitted a budget here for fiscal 1988 that would take us a long way toward doing that.

Senator **Conrad**. Let me ask you a couple of specifics, because I see this trade deficit as being devastating to the long-run economic security of this country. It just continues to grow. We do not have it under control. This year is going to show a record trade deficit again over last year's deficit.

Why shouldn't we consider the following approach: a fair share program on the revenue side that would aggressively attack the tax gap—that $100 billion a year that the revenue service says that is out there that is legitimately owed and due under current tax law. We wouldn't have a tax increase, but would bring in new revenue by aggressively pursuing that money that is legitimately owed and due.

In my State we enacted such a plan. We got a payoff of $15 for every dollar invested. And on the spending side, why not say to our friends in Japan—we look at these productivity numbers, very interesting. Japan has eight times more productivity growth than we have, and they spend 1 percent of their GNP on the military. The Germans whose productivity growth is five times as high as ours, spends 3 percent of GNP on defense, while we are at 6 percent. And I really have to wonder if we are not at a juncture where we need a radical departure from what we have done in the past and could say to our allies, look, it was appropriate after World War II, but now it is time for you folks to bear your own fair share of the defense costs so that we can become more competitive.

Why could we not take steps like that?

2,500 REVENUE AGENTS ADDED

Secretary **Baker**. Those are two stocks. Let me speak to both of them. In the first place, as far as the underground economy is concerned, we initiated in the fiscal 1986 budget an enforcement program which is going to pick up billions of dollars in added enforcement by adding 2,500 revenue agents per year to the Revenue Service. Now, we are going into the second year of that.

Senator **Conrad**. That is about $2 billion, as I understand it, that you have got targeted.

Secretary **Baker**. No, no, sir. That is what is in this budget. I was about to say, the first thing we have done is to do what I just mentioned. I can only take you back in my tenure as Secretary of the Treasury. But we started that in the fiscal 1986 budget. It is 2,500 revenue agents a year beginning in fiscal 1987, so we have got 1987, 1988 and 1989. We have got 1988 and 1989 still to go. The cost, I think, is something in the neighborhood of $500 million, but we will net about $5 billion. Do not hold me to that exact figure. So we are moving in that area.

In this budget right here, we have got a $2.5 billion revenue initiative in terms of additional enforcement.

Senator **Conrad**. But we are talking about $100 billion gap. I mean, could we not be more aggressive in going after that? It was $40 billion in 1976; now it is $100 billion. I come from being a revenue administrator, and really, I think it is unconscionable that we have got a situation where there is $100 billion out there that we are not collecting. And we ask all of those who are honest and come forward and pay their taxes voluntarily to keep on doing it, without aggressively pursuing those who are failing to pay theirs.

I know that the audit coverage has dropped in half over the last 6 years from what we were achieving.

Secretary **Baker**. Well, you see, I guess I would have to argue that we are being aggressive. We are certainly a heck of a lot more aggressive than we have been in the past, Senator. I guess we could argue or disagree on exactly how much we ought to commit to this, but we are certainly taking steps each and every year to a greater extent to try and pick up on the underground economy.

Mr. Chairman, should I answer the other part of his question on the defense spending thing, or do you want to move on?

Chairman **Chiles**. Certainly. Go ahead.

WHY PAY FOR GERMANY'S AND JAPAN'S DEFENSE

Secretary **Baker**. Senator, the argument you make has been made by others, and it is a very rational and logical argument. Why in the world should we pay for the defense of Japan and Germany when they are in surplus and they are continuing to beat us internationally and so forth?

For what it is worth, sir, the National Security community's response to that is we are not paying for Japan and Germany's defense. We are paying for the defense of America. And when we have troops abroad and when we have military equipment in the oceans over there, that is to defend you and me; that is not to defend Japan and Germany.

INCREASE IN REVENUE AGENTS

Chairman **Chiles**. Mr. Secretary, I hope that "we initiated in 1986" was a broad "we," sort of a collegial "we." I thought the Congress helped you initiate in 1986 that increase of revenue agents.

Secretary **Baker**. I am sure you did because if you had not helped us, we would not have gotten it. But I thought we proposed it, Senator. I am not sure. Maybe you added to it. We came with something, if I am not mistaken.

Chairman **Chiles**. Do you have a tracking system now that can actually trace what those agents are doing? You know, we keep saying, if we had so many agents, we would collect so much more money. Can we track that?

Secretary **Baker**. I think we can do some estimating on that.

Chairman **Chiles**. I would like to see what we really are doing.

Secretary **Baker**. It is the view of the Internal Revenue Service, I believe, that for every dollar spent on enforcement, we pick up ten.

Chairman **Chiles**. I have heard that a lot. I just want to know if there is a tracking.

Secretary **Baker**. I am not personally aware of a specific tracking mechanism, Senator, but I think that is what the IRS would say.

Chairman **Chiles**. I would like to see if there is a way.

[The following was subsequent supplied for the record in response to a written question from Chairman Chiles:]

IRS Revenue Yields

Question. You told the Senate Budget Committee that additional IRS agents bring in $10 for every $1 spent. The Administration's budget proposed $2.4 billion in additional revenue from a $624 million increases in the IRS budget, a 4.1 ratio. Which ratio is right? Do you support increases in IRS funding?

Answer. The 10 to 1 ratio of return to investment is an approximate historical measure. This ratio is an average of the various tax enforcement programs—examinations, appeals, collection, and document matching. The yield for some programs approaches 20 to 1, such as the collection and appeals programs. In the examinations program, the yield ranges from between 6 to 1 and 10 to 1.

Of the $624 million increase requested in FY 1988, only $384 million relates to direct funding for tax enforcement programs, and the remaining $240 million in for ADP and systems increases and mandatory cost requirements for all IRS programs. The tax enforcement increases, $384 million, will raise $2.4 billion in FY 1988, a return of 6.4 to 1.

The FY 1988 enforcement expenditures result in only an 6.4 to 1 return due to the learning curve of hiring and training new staff in the first year. By FY 1992, the revenue collected will total $3.4 billion, a return to yield ratio of 9 to 1.

The Department continues to support revenue increases for the IRS as an effective means to raise revenue in support of deficit reduction and improved voluntary compliance.

Chairman **Chiles**. Senator Domenici.

Senator **Domenici**. I will wait awhile. I think Senator Rudman was first.

Chairman **Chiles**. I think Senator Rudman was first.

Senator **Rudman**. Thank you, Mr. Chairman.

WHAT HAPPENS IF BUDGET FALLS SHORT

I really only have two brief questions, Mr. Secretary. First, on page 7 of your statement, you refer to the fact that there is less reliance on programmatic reductions. You say you are not relying—and you use the word "substantially" on spending cuts previously rejected by the Congress.

Your budget calls for $18.7 billion of programmatic reductions. The Budget Committee staff has estimated that your budget includes about that much in previously rejected proposals. My own calculations are that the total may be several billion higher than that.

But be that as it may, to me $18 plus billion is substantial. We could run our State budget in New Hampshire probably for a millennium.

I wonder what your fall-back position is. With the new political realities around here, we could not achieve those cuts when the Republicans controlled the Senate. We are now 55 to 45. I see even less likelihood of adopting those proposals. So obviously, we have got somewhere between a $10 to $14 billion shortfall if we take all of the figures as they are.

What is your fall-back position over at Treasury? How are we going to make up that gap?

Secretary BAKER. Senator Rudman, if I told you that the fall-back position was to make it up with additional revenues, then there would be absolutely no effort to get that $18 billion.

Senator RUDMAN. That is probably true, but there has not been much effort up to now, anyway.

Secretary BAKER. That is not our fall-back position, as you know. I think it is important that we have an opportunity working with the jurisdictional committees, to see if we cannot get some of those spending cuts.

In past years we have had this situation where the President's budget is declared dead on arrival. The political imperatives are said to be such that we cannot make these spending cuts. Somehow we keep this process going for month after month after month, and we end up getting, sometimes, more than we thought we could get. So we have to continue to try and make efforts to reduce the deficit at least 50 percent on the spending side. We are not coming up here this time the way we did in past years saying it has got to all come out of spending.

NO DIFFERENCE BETWEEN TAXES AND USER FEES

Senator RUDMAN. The second question is tied to the first one. I just really want a little definition of the rules of the game at the beginning of this 100th Congress.

I want you to tell me the qualitative differences between various revenue-raising proposals. I have been looking at this proposal. We presently have taxes that are quite similar to user fees. We have an airline ticket tax. We have a tax on aviation gas. We have one on gasoline for the Highway Trust Fund. Then we have sales taxes on tires, and we have use taxes for heavy trucks.

I want to know the qualitative difference between those revenue raisers and other kinds of excise taxes. Let us say excise taxes on alcohol, on tobacco and things of that sort. Is there a qualitative difference between those kind of excise taxes and the kind that are captioned in your proposal or that we are already levying?

Secretary BAKER. Well, excise taxes are excise taxes, and they are taxes. And in the President's budget under the heading "Governmental Receipts, there are proposals for $6.1 billion of additional receipts or revenues—call them what you will—that I think it is fair to say probably represent taxes. Last year, we proposed $6 billion of additional receipts that could fairly be said to represent taxes.

On the other hand, user fees that are paid only by people who are using a particular facility or service of the Federal Government are not taxes, as far as the President is concerned.

Loan asset sales, revenues generated through the sale of loans, are not taxes. Revenues generated through the sales of other governmental assets are not taxes.

Senator RUDMAN. Well, there is not, though, is there, a qualitative difference between a sales tax on tires or airline tickets and a sales tax on tobacco or alcohol? There is no qualitative difference.

Secretary BAKER. No.

NO EXCISE TAXES IN LIEU OF SPENDING CUTS

Senator RUDMAN. If I understand what the President has been saying consistently—and I agree with—is that we are not going to have any broad ranging changes in personal or corporate taxes, particularly this year when we have just passed historic—to use your word—tax reform. We are not going to start fooling around with those numbers.

But if, in fact, tying back to my first question, we are $14 to $18 billion dollars short of the deficit targets, then we have to look—if we are looking for revenue, into what you euphemistically call—and I guess we all euphemistically call—revenue changes, governmental receipts, user fees, taxes and so on.

Am I correct about that, Mr. Secretary?

Secretary BAKER. Well, if you are assuming that the administration would be agreeable to substituting for the $18 billion in spending cuts is in our budget an increase of excise taxes, the answer is no.

Senator RUDMAN. I understand that is your initial position.

Secretary BAKER. I have to tell you, Senator, that I have worked for this President now for 7 years, and this does not represent an initial position, in my opinion.

Senator RUDMAN. Well, I appreciate your answers. They are about what I expected and they are accurate, and I daresay that we are going to try to get that $18 billion. I voted for a lot of it before and I will vote for it again, and I will be on the losing side. Then we will go on and do something practical.

Chairman CHILES. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Mr. Secretary, it is a pleasure to have you here today, and I appreciate all the hard work you are out there doing in your department.

There has been enough, I think, reaction already to the budget from members of both sides of the aisle and both House and Senate to make it clear that major adjustments are going to have to be made in the budget. The priorities are not ones that are generally supported here, either by previous votes on a bipartisan basis, nor is the support there now. I am speaking about things like cuts in education and Medicare and veterans' health programs and things of that kind.

The Senator from New Hampshire raises equivalent questions on the revenue-raisers that are also in this package.

BUDGET SUMMIT MEETING URGED

Many of us yesterday with Budget Director Miller suggested that we try to see what we could do on a bipartisan basis with some kind of a serious budget meeting, a summit meeting of some sort, to see if we cannot find some way to go through the give and take on the front end here and come up with a package that is acceptable all around and workable and that continues to take these deficits down.

I would like to urge that course of action on you and ask you to consider it, and perhaps argue for that within the administration. And I do so because I think we are at a point in the road where we are going to go one of two ways. We either will find, I think, that if there is an effort to tough it out with this budget as it stands now and will probably not get too far in a cooperative way and the year will go by. And we will have missed an opportunity for a budget breakthrough that I think possibly we could reach if we were to sit down and try to work on it together on a bipartisan basis.

I think you will find that there are many of us who hold that view. I am prepared to make some cuts in areas that I support as a part of an overall package that really gets the job done.

I would hope that there would be some serious interest in that kind of a meeting on the administration side. There has been almost no effort to talk that way in putting this document together.

So I think the time is ripe to try to do that, and I would encourage you to think about it, and to ask if it sounds like a sensible idea, whether you could help us pursue that approach.

Secretary BAKER. Well, Senator Riegle, I certainly think it is sensible to talk about approaching this very difficult problem through consultation and negotiation. At the same time, as in past years meeting there have been suggestions that there be some sort of a major, at the very upper levels of government—a budget summit. That has always been in the President's view a code word for let us put a tax increase on the table, and he is just not in a position to do that. I mean, he is just not going to do that.

Senator RIEGLE. I do not think it has to be read that way. I do not intend for it to be read that way when I make that point. You folks have put revenue on the table in this document. There are several billions of dollars of revenue in here, so that is not a new issue.

Secretary BAKER. Absolutely.

Senator RIEGLE. I do not think we should trip over the tax issue. I do not think the votes are here for any kind of a broad across-the-board tax increase. Certainly, I am not prepared to vote for one. And I do not think that ought to block us from having the kind of serious discussion to lead to a breakthrough.

Frankly, if you do not have the discussion you are not going to get the breakthrough, and we are just going to struggle here for a year. And the country will be the loser for it.

OUTSTANDING INTERNATIONAL DEBT ANTICIPATED

The second thing I want to raise with you is this: The New York Federal Reserve Board now says that the trade deficit is running at such a severe level that by 1990 we are going to have an international debt outstanding to the rest of the world of about a trillion dollars. That is their official estimate.

Now, I must tell you, I do not know how we can handle that kind of buildup of international debt without creating enormous dangers to our own financial future. Obviously, at the same time there is this tremendous job loss that goes with the trade deficit.

But I am wondering whether this country can support an international debt to poor nations within such a short time frame as 1990 of a trillion dollars. Can we really let our kind of debtor nation status rise to that level without putting ourselves in real jeopardy?

Secretary **Baker**. Senator, it would be, in my view, very unwise of us to assume that we should, even if we could. And I am not sure there is any hard evidence that we could not, but it would be a very foolish thing to do.

I happen to believe that the trade deficit, contrary to what Senator Conrad said, is, indeed, leveling off. I realize what the November figure was, but again, I think that was an aberration caused by yearend imports, as imports were seeking to get out in front of the expiration of the sales tax deduction and the imposition of a customs import fee and all the rest.

I think if you go back and look at it on a 6-month basis from, or let us say, February of this year, we will see that the trade deficit, while it had not declined and it remains a major, major problem for the reason you point out, has nevertheless begun to level off.

Senator **Riegle**. Even if it levels off, it was roughly $173 billion. Suppose it levels off to $150 billion or even $125 billion? That would be a substantial improvement but that still piles up.

Secretary **Baker**. It still piles up that debt, and it would be foolish——

Senator **Riegle**. And I just do not know how we are going to service that debt, quite frankly. I mean, we have got the build-up of our own internal national debt. I do not know how we can afford to let that international debt continue to rise at those levels.

301 UNFAIR TRADING CASES PROSECUTED

Secretary **Baker**. Senator Riegle, we ought to do everything we can to avoid that happening. We have been taking some action over the course of the last year, 18 months or 2 years to try and do just that.

You are familiar with what we have done on exchange rates. You are familiar with the 301 unfair trading cases that we have been prosecuting vigorously—the first time in history we have had a President to self-initiate such cases. You are familiar with the efforts we have made to open markets abroad; the efforts we have been making to get other industrial democracies to increase their growth, particularly the surplus countries, so that they can begin to take products from us. We need to do that and more.

Senator **Riegle**. Well, my time is up, but the numbers are not changing dramatically and they have to change dramatically. So more is going to have to be done.

Secretary **Baker**. I would only add one thing, Mr. Chairman, if I might.

As you know, Senator Riegle, there is a great lag time before numbers change as far as the trade deficit is concerned, particularly if the factors causing them to change are exchange rate changes.

Chairman **Chiles**. Senator Nickles.

INCREASE PROPOSED FOR MULTILATERAL DEVELOPMENT BANKS

Senator **Nickles**. Thank you, Mr. Chairman.

Secretary Baker, I look forward to working with you. You mentioned a couple things, for example, to Senator Conrad about the fact that we cannot spend ourselves out of some of the economic problems that we have in the Farm Belt and the Oil Belt and the rest of the belts and I would agree with those.

I looked at the proposal, and you also stated in your opening statement that you felt like it was important for us to fund the administration's proposals for the multilateral development banks. You are going to have to do a lot of convincing to this Senator, and I happen to be sitting on the Appropriations Committee as well, for that area so that we can justify that amount.

I was just trying to look through the proposal, and I think I see in the supplemental for 1987 about $300 million for multilateral banks, and then between 1987 and 1988 another $500 million increase, an increase from about $1.4 billion to over $2 billion. That is about a 30 percent increase between 1987 and 1988.

That concerns me, and then when we tie it back into some of the agriculture problems which have been discussed, I have to look at some of those loans that the IDA has made. They made a $350 million to Argentina to increase wheat exports—that certainly hurts the Wheat Belt, which our state, of course, is a member of—a $450 million loan for Brazil so they could increase exports in soybeans and other commodities. There is at least one Senator who has written letters to the bank member or head of those banks urging them not to do that. You mentioned that the United States has had considerable influence over those banks in the past. Well, if that is the case, we have not objected to those banks making loans to competing countries in agricultural areas, particularly in areas where we already have surpluses.

So, again, I do not see the justification for that increase. I think you have got a sales job to do when you are asking us to make reductions in farm price supports of 10 percent per year for the next 3 years; and yet you are asking for a 30-some percent increase for the multilateral banks.

Can you justify that?

SOYBEAN PRODUCERS ASSOCIATION SUPPORTED LOAN

Secretary **Baker**. Well, yes. I think that Brazilian loan, for instance, for agricultural extension that you mentioned was one that we objected to. I believe that was the loan. I do know that we object to loans to produce commodities that are in over supply. And we objected, if I am not mistaken, to the Argentinian loan.

Senator **Nickles**. The Argentine loan went through.

Secretary **Baker**. It went through, but we objected to it.

Senator **Nickles**. It did not solve the problem. There is a $350 million loan in Argentina, 3 years where they do not—I will check these facts—have to make an interest payment for the first 3 years, a low-interest loan to increase their agricultural exports in wheat.

Secretary **Baker**. Well, what I am saying is I think we clarified the consequences of the Brazilian credit and manufacturing reform loan so that it was supported by the soybean people. Brazil, as a part of that negotiation, dropped certain import restrictions against our products into Brazil.

Senator **Nickles**. That may be the case.

Secretary **Baker**. We objected to the effects of the Argentine loan. We do not control those institutions, but we have a great deal of influence in them.

We routinely vote, Senator Nickles, against loans to produce commodities that are in over supply. But let me just say one thing generically about this. Some of our best markets, some of our very best markets, used to be these countries of South and Central America that are so heavily saddled with debt. It is important that we try and find a solution to that problem—and the multilateral banks are very instrumental in that—so that the wheat producers of Oklahoma and Texas can resume once again exporting products to Central and South America.

Senator **Nickles**. Well, let me encourage you in your efforts that in any future loans that we do make in those regards we do not use those loans for increasing surplus commodities. That just compounds the problem.

Secretary **Baker**. We agree with that.

$11.2 BILLION PROPOSED IN LOAN SALES

Senator **Nickles**. My time is almost gone. A quick question: Can you tell me how many billion dollars worth of loan sales are in the total proposal?

Secretary **Baker**. To my recollection, without looking at the data here because I do not have it right here in front, it is $11.2 billion in face-amount loans to generate $5.3 billion in net revenues.

Senator **Nickles**. I am interested in that proposal. But then again, when you look at a face amount of $11 billion and you look at our cash received at $5 billion, I am not sure that it is that positive of a cash flow.

Secretary **Baker**. Well, Senator Nickles, I understand what you are saying. You are asking, basically, are we not just selling loans at fire sale prices in order to reduce the deficit? And the answer is, categorically no.

These loans will be sold through public auction; they will be sold at their fair market value. What this points up, I think, is that we all need to know—the executive branch and legislative branch—what we have been doing over the past few years by putting these loans on the books.

We say, well, this is just a loan guarantee; we do not have to worry about this having any effect on the deficit. The fact of the matter is that much of that paper is no good, quite frankly. We are sort of happy we can get 50 cents on the dollar for some of it. And we have got some paper in the Federal Financing——

Chairman **Chiles**. You have not gotten 50 cents on the dollar for some of it yet, either.

Secretary **Baker**. We have not gotten it yet, either. That is right. It is an estimate, Mr. Chairman. You are quite right. But I can promise you this: We have got some paper in the Federal Financing Bank that would not bring 50 cents on the dollar.

So I do not think it is fair to say that we are somehow making a fire sale here.

Senator **Nickles**. I did not make that statement. I said I am interested in the idea. The amount that you are selling, as far as the portfolio goes, is minuscule.

Secretary **Baker**. That is right.

Senator **Nickles**. And if it is a good idea, you could sell some good paper, too.

Chairman **Chiles**. Senator Simon.

Senator **Simon**. Thank you, Mr. Chairman.

First of all, I would like to second the recommendation of Senator Riegle that some kind of a summit meeting be held. The reality is we have revenue on the table right now in the user fees. Whether you want to call them tax increases or not, that is what is there.

I remember when I first got elected to the state legislature in Illinois, a man in South Roxana, Illinois, wrote me a letter. He had 13 points to his letter; the first 12 were increased services he wanted from government, and the 13th point was cut taxes. Believe it or not, we have adopted his program.

Now, we have to back off, and we have to make some painful choices, both on the spending side and on the revenue side. And I want your grandchildren, Mr. Secretary—and I happen to think you are one of the ablest people in government—I want your grandchildren to read about your service as Secretary as one where we finally got a hold of this problem and started moving in the right direction.

Now, if I can toss a couple of questions at you.

Secretary **Baker**. Go ahead, sir.

EDUCATION SYSTEM NEEDS CRITICAL EXAMINATION

Senator **Simon**. I was interested in the portion of your statement on American competitiveness. I read through it very generally with approval. I note that almost everyone else, though, who talks about American competitiveness, including John Young, the CEO of Hewlett-Packard, who did this study for the President, put great stress on the fact that we are going to have to do more in the field of education in the United States.

I find that lacking in your statement, and I find it lacking, frankly, in the budget where we cut back $5.7 billion on education. Do you have any comments either on your statement, whether it was just an unintentional omission?

Secretary **Baker**. It was omitted because, quite frankly, Senator, as you pointed out, there is a reduction in the expenditures. But the fact of the matter is we believe, and you will see more reference to this later on after the state of the Union, that we need to do a lot of things to increase our competitiveness. One of the things we need to do is to look at our educational system and reexamine it critically. And I know you would agree it is not enough just to throw money into education. We need to see whether or not we have a competitive educational system and compare it with, for instance, the Japanese system.

We need to do the same thing, as we have suggested, with our business establishment. Are we competitive? Are we lean and mean? Some businesses obviously have become lean and mean recently. Is there room for others to do more?

These issues are not in this budget. These are not dollar and cents issues. You will see them addressed but it will be later on. But if your question to me is whether this really is a part of our becoming competitive, you are absolutely right, it is a part.

Senator SIMON. I would just add, I think if you will check with the members of the Senate from your party who have been active in education, like Senator Stafford—and I have not talked to him about this budget, but I am fairly confident he would say we are not moving in the right direction at all as far as the very concerns that you have expressed.

For example, the budget cuts $900 million out of vocational education. You know, I just cannot believe we become more competitive by cutting out $900 million on vocational education. So I would just urge my colleagues and the administration to take another look at that.

BE CAUTIOUS ABOUT ASSUMPTIONS

Then I would add one other note of caution. You say you are not looking at this in rosy terms. The two econometric systems that were most accurate for this year were Wharton and Chase. Their projection for 1987 is growth rate in one case of 2.7 percent; in one case they are talking about 1.8 percent. I think that suggests that we had better be pretty cautious about assumptions on where we are going in terms of growth.

Secretary BAKER. For 1987, Senator?

Senator SIMON. That is correct.

Secretary BAKER. Yes; I understand. I think that is right. The average, however, of the Blue Chip forecasters is 2.9 percent on a fourth-quarter to fourth-quarter basis; whereas, we project 3.2 percent, which is really pretty close.

Senator SIMON. And what does that mean for the deficit?

Chairman CHILES. 2.9 or 2.5 percent is the average?

Secretary BAKER. 2.9 percent, forth quarter to fourth quarter.

Senator SIMON. I guess I am getting different figures. I have the impression that your projection is 3.5 percent. Is that incorrect?

Secretary BAKER. Yes, it is incorrect; 3.2 percent, Senator.

Senator SIMON. 3.2 percent.

Secretary BAKER. Yes, sir.

Senator SIMON. And can anyone, either the Secretary or anybody on the staff, tell me the difference? What does one percent variation in GNP growth mean in terms of deficit?

Senator LAUTENBERG. $4 trillion.

Senator SIMON. But it is not $4 trillion on the deficit?

Senator LAUTENBERG. No, no. On the GNP.

Secretary BAKER. The total GNP, we have a $4½ trillion GNP.

Senator SIMON. Yes.

Secretary BAKER. The deficit effect of a 1 percent GNP differential for the course of 1 full year would be maybe $10 billion on perhaps a little more on the revenue side.

Senator SIMON. I have an idea——

Senator DOMENICI. On the revenue side only, Senator Simon. The $11 billion I just quoted out is revenue loss or gain for one point. There are other impacts.

Senator SIMON. But the $11 billion, plus you have loss and you are going to have to increase welfare expenditures and a lot of other things.

I see my time is up.

Chairman CHILES. Senator Symms.

Senator SYMMS. Thank you very much, Mr. Chairman.

Mr. Secretary, we welcome you here to the committee. I have just returned from spending most of the last 4 months in Idaho, and it is part of a depressed regional economy. The general public out there feels that we are in a depression. It is certainly a recession because of the agriculture sector, the mineral sector, and the timber sector. But I am not one of your critics on your overall statement of 3.2-percent real economic growth. I would urge my colleagues and people in your department, if you missed it, to read the article that was in the paper yesterday by Warren Brookes, where he makes the point that the economic news keeps coming out in dribs and drabs, and there is a general reporting, a negative reporting of predictions of a recession in 1987, when actually we may be in a growth period. And we are in a growth period overall.

That is not true in my State and it is not true in Oklahoma and, as Senator Conrad said, North Dakota, but in some parts of the country we are. So I think there is a chance here that our growth rate may even be more than the 3.2 percent that you are predicting.

INCREASE TIMBER SALES

I still have some problems with some of the suggestions in this budget. For example, the budget brings up a suggestion to change the way payments in lieu of taxes are calculated, from the gross value of timber sold to the net value. Now, we just got that corrected in the last Congress. Now this proposal comes along and brings that whole can of worms up again.

We would not be complaining about this except that in many counties in my State, the Federal Government owns 90 percent of the real estate and the timber. Then when they want to reduce the counties' abilities to pay their bills—when they want to cut the rural commitment in the budget and at the same time reduce the amount of money rural communities get from timber sales, they simply do not have any place to turn to pay for their local services.

So, you know, if this land were privately owned and managed like it is in many States, the Southwest or Maine, for example, I would not be bringing this up. But I would just say that anything you could do to encourage the Agriculture Department to increase timber sales would be very helpful in the whole region of the Pacific Northwest because we have got a lot of old timber out there that is not growing any more. It is overmature. We need to harvest it to compete with the Canadians. We need it to compete with other domestic timber regions, and we are not getting enough timber sold through the Forest Service. So I would urge you to encourage the administration to do that.

I would like to go ahead now with a question or two about the issues that Senator Nickles brought up. I have a problem with this, and I quote from an article in the Wall Street Journal. This is an article from April 10, 1985, so it goes back a ways when the Reagan administration was trying to drop some of the money that was going in the International Development Banks. I just want to quote this one paragraph.

"Given the Reagan administration advocates free markets, deregulation and privatization as a means for promoting economic growth at home, it would be disingenuous to embrace IDA funding that is used to establish public institutions that promote suffocating market interventions, regulations and nationalizations abroad."

AXING CONTRIBUTIONS TO MULTILATERAL DEVELOPMENT BANKS

Would you comment on that? In other words, to get the question more specific, if we lend money to Communist China interest-free for 50 years through the International Development Banks, and they reinvest in Japan and the United States, and it ends up increasing competition for our wheat growers and our mineral producers and our other commodity production sectors of the economy, is this not a very poor policy for the United States to pursue? Would we not be better off just to axe this entire segment out of the budget and not make our taxpayers pay for their own competition?

Secretary **Baker**. Senator, do you mean axe our contributions to the multilateral development banks?

Senator **Symms**. Yes.

Secretary **Baker**. Well, I think that would be a terrible mistake, Senator Symms. If you think that the United States should remain a major player on the world scene, is politically and economically, it would be like saying that we are just going to pull back here and to put some walls around this country, that we are all going to withdraw, and whatever market we have here is going to be the market that we are going to seek to sell in.

We do very well by competing in world markets, generally speaking. And if the United States is going to remain a world power and a leading player on the world scene, we should not withdraw from participation in the international financing——

Senator **Symms**. Well, on one hand, we are making an enormous payment to protect the income of American farmers with the target price.

On the other hand, we are now talking about dumping in $300 million this year and a billion dollars next year to go right out and increase production of those very same commodities.

Secretary **Baker**. Senator, I could not disagree more. A very, very small amount of that will find its way into the production of commodities that are currently in excess, as my response to Senator Nickles' question indicated. There may be some small portion of it that will, indeed, find its way into such commodity production over the objections, I might say strenuous objections of the United States, because we routinely now object and vote no whenever a loan is on the books that would increase the production of commodities in over supply.

There are many, many other loans that are made by those institutions that I would say have substantial collateral benefit to the United States in terms of enhancement of the world economy generally. We live in an interdependent world, and we are dependent on the world economy to the same extent that some of those other countries out there are dependent and have in the past been dependent on us. It would be a terrible mistake for us to withdraw from those institutions.

[The article referred to by Senator Symms follows:]

[From the Washington Times, Jan. 7, 1987]

OVERLOOKING THE POSITIVES

(By Warren Brookes [1])

The huge $19 billion trade deficit for November took everyone by surprise, and thereby hangs an ironic tale. While the deficit was universally regarded as bad news, especially by the Commerce Department, almost no one noticed what this development says about our supposedly "sluggish" economy.

It isn't sluggish at all. Imports for the first 11 months of 1986 are up 8.7 percent over 1985, and with the total import price index (Sept.-Sept. 1985-86) down by 9.8 percent, this means a real increase of roughly 20 percent—very, very strong.

This means the fourth-quarter gross national product figure, even with the trade deficit, could easily finish up at 4 percent, and for the whole year at 3 percent. Along with an inflation rate of 1.3 percent, this makes 1986 one of the best economic years in two decades—with 2.2 million new jobs and the highest employment ratio in our history, and in the world; real personal disposable income up 3.3 percent; help-wanted ads at an all-time high; future economic indicators soaring.

Given the almost relentless gloom and doom (remember the Democrats' charge of "34 states in deep recession"?) and constant predictions of imminent recession, the media and its "experts" should be thoroughly ashamed of their performance. Most of what we were told about the economy in 1986, from ABC to CNN, from CBS to NBC, and even to CBN, was simply baloney.

While most of this is the press's fault, some of it arises from the increasingly shoddy economic data from the government, principally the Department of Commerce, whose sampling of data sources seems more and more out of date with a changing economy.

I give you as Exhibit No. 1 a series of reports on the November retail economy beginning on Friday Dec. 5, and concluding on Friday Dec. 26, a series that ran the full gamut from bust to all-out boom, all covering the same basic data base.

On Friday Dec. 5, news readers were told "Retailers Post Weak Sales for November," with the Associated Press release focusing on the "flat" performance of Sears, Roebuck and J.C. Penney in a list of 18 chains. As The Wall Street Journal said, "Most big chains posted weak sales gains for the four-week period . . underscoring consumers' tepid finanical condition."

But a week later, on Friday Dec. 12, news readers learned that November was a "fairly strong retail month," with Commerce showing a "surprising" 6.2 percent annualized rate of gain, or a very strong 4.8 percent real rate of growth.

Then, a week later, on the 19th, Commerce reported that consumer spending in November had jumped an astonishing 1.1 percent in one month, a more than 12 percent annualized real rate of gain. This came on top of two consecutive quarters of more than 6 percent real growth in personal consumption expenditures—boom levels.

Small wonder the WSJ reported this event as "surprising economists . . . as spending was strong across all categories," with real consumer spending after inflation at a new record pace!

Yet, the very next day, on the 20th, The Washington Post led its business page with a story that "Retailers Report Ho-Hum, Not Ho-Ho," telling readers that "retailers here and across the country say that so far they've had a blue Christmas." The theme was predictably picked up by most of the network news shows.

The Post, whose business page predicted imminent recession in August and September, quoted the district manager of J.C. Penney's: "It's going to be OK, but not double-digit increases—more like a 7 to 8 percent sales gain."

Within this statement, however, is summed up one of the reasons for at least some of the confusion. An 8 percent sales gain in a year when annualized inflation is 1.3 percent (through November) means a 6.6 percent real growth in revenues. That may well be one of the better "real" growth years in Penney's history!

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[1] Warren Brookes is a nationally syndicated economics columnist.

In the 1970s, retailers got used to 10-12 percent annual sales "gains," but with inflation then running 8-12 percent a year, they were lucky to wind up with 2-4 percent real gains.

So, when the major department store chains reported on Friday Dec. 26 a "moderate 8-10 percent gain over last year," for the Christmas season they were actually reporting a sensational 6-8 percent real growth in consumer spending!

Another reason retail growth has been so badly underreported each month is that the top two or three chains have been losing market share to booming newer, smaller chains. Shallow reporters (like the outdated Commerce Department sample) look at Sears, Roebuck's weak 2 percent rise and assume the whole retail market is "flat," while ignoring their bustling competitors.

For example, Wal-Mart, the sprightly new Arkansas-based discount chain, is sporting a whopping 41 percent, $3 billion increase in volume this year. Also, Zayre's, Ames's, and Bradlee's have been posting gains of 32, 29 and 19 percent respectively.

As a result, total sales volume for the top 18 chains this year was up a very husky 9.4 percent this year through 10 months, or a record-challenging real growth of 8 pecent. Yet the Commerce Department's own numbers for consumption of "non-durable goods" which make up most of these chains' sales show they declined at an annual rate of nearly 1 percent in the third quarter, and its year-to-date to total retail sales are only up a supposed 4.9 percent!

With Commerce data bases as bad as this, no wonder the nation has no idea of where its economy has been, let alone where it is headed, which at the moment, appears to be straight up.

Chairman CHILES. Senator Lautenberg.

Senator LAUTENBERG. Thank you, Mr. Chairman.

GUARANTEED LOAN SALES

Mr. Secretary, one of the things that has been left out of this year's vocabulary is the phrase "smoke and mirrors." For some reason or other, I guess it has worn itself out. But I think we are doing a little bit of that.

I was one of the early proponents of loan sales. At that time there were a lot of skeptics, even snickers. Some people said that is a terrible idea.

I do not think it is a bad idea. In response to the earlier questions about whether or not we are getting face value for these things, I think you correctly point out, and you did so in your message as well, that it is about time we recognized the subsidy on loans that we are giving. It is a real cost to government. That is precisely the way it ought to be handled.

What concerns me is the now almost addiction, if I may use the expression, or certainly a dependence upon one-time opportunities, that extend beyond loan sales. I totally agree that as we create these loans, if these are subsidized loans, if these are below market, we ought to get it out there in front of the public and in front of everybody here so we know exactly what we are doing. I do not know that it is a terrible idea, but at least we ought to reckon with it.

GOVERNMENT ASSET SALES

When we talk about the sale of other assets, of privatization—I'm concerned. Coming from New Jersey, I would not be very amenable to the sale of Amtrak and I hope that it will never take place. We would be one of the few nations in the world, developed nations, where government was not directly involved in providing efficient rail transportation.

But I look at, for instance, something like the sale of the Naval Petroleum Reserve which shows a substantial income, this year, of $2.5 billion; next year about $300 million, looking out to 1989; and then the thing reverses itself, and it looks like a recapture of the costs for otherwise meeting the needs met by those reserves. As I look across, it is about $1.8 billion in the 3 years following 1989.

So are we, Mr. Secretary, doing things this year that give the effect of satisfying the objective, meeting the target, when realistically it is the Peter and Paul story and we are not really solving the problems?

Secretary BAKER. Oh, I disagree, Senator Lautenberg. I do not think that one-shot deficit reduction is worthless. I think it is very valuable. And just because it does not translate into out-year savings does not mean that you cannot confront that problem in the year in which it is a problem.

And, again, accepting for the moment the fact that there are great differences here with respect to whether these spending cuts ought to be enacted and some of these asset sales should be moved forward, if this budget became law, we would have the deficit down substantially; and nobody would argue that we were not well on the road to major, major deficit reduction in this country.The deficit would be under 2.5 percent of GNP. It would be lower, I think, in terms of the deficit as a percentage of GNP, than of any of the major industrial nations save Germany and Japan, if this budget becomes law. So I think it would really put us in good shape even if it was just a one-time thing.

And with respect to the philosophy of it, I understand your comment about New Jersey and I accept that and understand it. But the question, I think, is whether or not the U.S. Government, the Federal Government, should be in the business of producing oil, should we be in the business of running railroads, should we be in the business of running airports? If we believe in a free market economy, are not there, after all, functions that are better performed by the free market?

Senator LAUTENBERG. Mr. Secretary, you come from a big state, and you know very well that some of your cities and cities that are represented by people around this table would be abandoned if we said, OK, let us make this a totally free market, whether it is airports or railroads or what have you. And there are certain services that I think are an obligation of Government, including maintaining an economic base, whether it is regional or national, that is essential to the functioning of our country. And, certainly, I see providing a transport system as one such essential function of government.

TOTAL LOAN SALES AVAILABLE

Let me ask you this question: This year we are talking about a net, I think, of slightly over $4 billion in loan sales. And, again, I am a proponent to a point.

Do you have a quick impression of what the total opportunity for loan sales is? Now, I am not talking about the annual occurrence where we take the discount, take the subsidy and put that down as the net cost, but rather——

Secretary **Baker**. Do you mean what is our inventory?

Senator **Lautenberg**. Yes; that could be realistically available for sale. We cannot do foreign military sales.

Secretary **Baker**. All I can speak to is the face amount, Senator, and it is my understanding—and we will go back and get the exact numbers for you—but it is my understanding that we have roughly $155 billion face-amount paper in the Federal Financing Bank.

I think $19 billion of that, roughly, or something in that neighborhood, is foreign military sales paper. The rest of it would be, I suppose, paper that would be eligible for loan asset sales should we decide to do so.

Senator **Lautenberg**. I have no problem with it. Thank you.

[The following was subsequently supplied for the record by the Treasury Department:]

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

23 JAN 1987

Dear Senator Lautenberg:

This is in reply to the request for information on the Federal Financing Bank (FFB) that you made of Secretary Baker during his appearance before the Senate Budget Committee on January 8.

As of October 31, 1986, the FFB portfolio totalled $157.4 billion, of which the Department of Defense-guaranteed foreign military sales loans totalled $18.9 billion. I have enclosed an FFB press release that summarizes FFB activity during the month of October, 1986. This release shows FFB holdings by program and divides those programs into categories of Agency debt held by the FFB, Agency assets held by the FFB and United States Government guaranteed lending done by the FFB.

Please let me know if I can be of further assistance.

Sincerely,

MIKE HUDSON

J. Michael Hudson
Assistant Secretary
(Legislative Affairs)

The Honorable
Frank Lautenberg
United States Senate
Washington, D.C. 20510

Enclosure

cc: The Honorable Lawton Chiles
The Honorable Pete Domenici

Chairman **Chiles**. Senator Quayle.

Senator **Quayle**. Thank you, Mr. Chairman.

I would like to join those in expressing my appreciation for the outstanding job you have done for 6 years, particularly the last 2 years, as being Secretary of Treasury.

HOW TO REACH ECONOMIC PROSPERITY

Let me ask sort of a broad question on what our economic agenda is. I listened to the discussions and we have heard talk about the budget. There has been a lot of talk about American competitiveness and things of that sort. But if we want to just say to the Nation, and I am not asking you to preempt the President's state of the Union address, what three things the administration is really searching for in these next 2 years with this Congress that will be on the economic agenda which will generate the economic growth, jobs and opportunity?

Can you give me three specific things that you really want to see happen up here?

Secretary **Baker**. Well, let me say that our objective on the economic side, Senator Quayle, would be to achieve—and if I may be a bit partisan here, let me say that this was the message that the President conveyed in the campaign back in 1980—to achieve as best we can for the United States sustained economic growth without inflation.

In my statement, I hope I pointed out that it is our view that over the course of the past 4 years we have been successful in doing that. Others have suggested, and I do not think improperly at all, that there are some problems and there has been some cost in the manner in which we have achieved it. Two major problems, as I see it, and let me limit it to two if I can, are the fiscal deficit and the trade deficit.

What would we like to achieve? We would like to see meaningful reduction of this fiscal deficit. I agree with Senator Domenici when he says it is related to the trade deficit, and so it is a part of getting the trade deficit down as well. We would like to see——

Senator **Quayle**. Does that mean a trade bill?

Secretary **Baker**. Here is what it means——

ADMINISTRATION APPROACHES TO ECONOMIC COMPETITIVENESS

Senator **Quayle**. Let me just say what I am searching for. I understand that we want deficit reduction. I understand that we want economic growth without inflation. But if we go back, we had budget reconciliation the top priority of the administration in 1981. You were very instrumental with the members of this committee getting that through. We had TEFRA I, we had TEFRA II, we had tax reform last year.

What I am searching for this time is what is going to be the centerpiece for these next 2 years of the economic agenda of the administration that is going to see the continuation of this economic growth? I know what the overall objectives are. Is it going to be just holding down responses that are going to come from Capitol Hill because they are probably going to be different with the change in the political requirements in the Senate? Or do we have some specifics, like a trade bill? Do you anticipate that we really do need a trade bill to bring down the trade deficit, that will, in fact, bring down the budget deficit?

I am searching for what this economic agenda is going to be without preempting the President's state of the Union. I would like to just get some sort of idea about it.

Secretary **BAKER**. Well, without preempting it, let me say that I think that the President will seek a collection of measures, some of which will be legislative in nature and some of which will be administrative in nature, which would make American more productive and which would make America more competitive.

Senator **QUAYLE**. OK. We are all for that.

Secretary **BAKER**. Well, you told me you did not want me to preempt the President.

Senator **QUAYLE**. OK.

Secretary **BAKER**. And even if you wanted me to, I could not.

Senator **QUAYLE**. Go ahead. Preempt him.

Secretary **BAKER**. No, I cannot.

Senator **QUAYLE**. OK. Well, we look forward to it. I do hope that there will be some very specific measures that we can say, all right, here is our economic agenda. So when we get that question beyond January 27, we will know precisely what that economic agenda is.

And, believe me, I have supported the administration's agenda in the past, and in all probability I would be willing to support it these next 2 years, as soon as we get a good understanding of where we want to go.

Secretary **BAKER**. When I said collection of measures, Senator Quayle, they will be specific and they will be laid out. Some will be legislative and others will be administrative and some of other natures.

Senator **QUAYLE**. I hope we will know when the 27th gets here.

Senator **DOMENICI**. What he is telling you, Senator, is that the budget is not the beginning and the ending of everything.

INDEXATION

Senator **QUAYLE**. Well, we will find out.

I see my time is about running out. Last year, I asked you about the indexation of Treasury bonds and Treasury securities. At that time you were very cool toward the idea. I mean, you were polite but cool; as a matter of fact, you were rather cold toward the idea. I think it was a rather direct, polite no as you can do from time to time to your friends up here.

Since that time, I am sure you have looked at it more. There has been a lot of editorial comment, such as in Forbes magazine. The Federal Reserve Bank of Boston, as a matter of fact, has endorsed the concept.

I wonder if you have taken a look at this idea which, in fact, will go toward reducing the budget deficit. It is not the normal indexation which everybody is fearful that you are going to lock in inflation, because with indexation of bonds, there would be a real penalty if inflation comes back to the Government.

On this one there is an incentive to hold inflation down. Britain has tried it, somewhat successfully. I just wondered if you, since throwing such cold water on it a year ago, have warmed up a little bit to the idea.

Secretary **BAKER**. I still have the same——

Senator **QUAYLE**. Are you more openminded this year than last?

Secretary **BAKER**. Senator, I still have the same problem with it that I did last year, and that has to do with the accuracy of your statement that it would help us hold down inflation.

I am really not sure that it would not work the other way, to be very frank.

Senator **QUAYLE**. Well, let me just say this. My time is up.

Chairman **CHILES**. It is up.

Senator **QUAYLE**. If that is your major concern, I think I can show you that the incentives would be to hold down inflation. I do not think this will actually have that much of an impact one way or another, whether we will have inflation. But I think there will be an incentive from the Government to hold down inflation because of indexation.

Chairman **CHILES**. Senator Wirth.

Senator **WIRTH**. Thank you very much, Mr. Chairman.

Mr. Baker, I want to join with my other colleagues in commending you and your right hand, Mr. Darman, for the great care and competence with which you have operated in your time in this Administration.

BUDGET SUMMIT WITH PRESIDENT

I also want to reflect on the suggestion made by Senator Riegle, Senator Simon, and so many members of this panel yesterday about a budget summit. I remind this panel that we did that in 1980, just before this President came into office, when the House, Senate and members of the administration got together and made some very real progress on a budget deficit that was beginning to creep up. And it was very productive. There is a precedent for convening a summit.

We had the advantage of having all the Democrats in control of the House, the Senate and the White House, but it nonetheless was a bipartisan effort. It cannot be done, clearly, unless we all want to do it and keep the level of rhetoric down. It was suggested here earlier by Senator Lautenberg that the phrase "smoke and mirrors," has not been used; dead on arrival has not been suggested. I would hope that, as you all move into the State of the Union and so on, that you will do everything you can to keep down the rhetoric on your side and avoid a "tax-and-spend Congress" and all of the rhetoric on the constitutional amendment to balance the budget so we do not have to turn around and say, well, why did you not submit a balanced budget and all of that cycle.

We can work responsibly toward this. I certainly hope that that can be done and that you are getting the feeling here, as I believe Mr. Miller did yesterday, of the real concern for making some progress together on this. It is just not going to be done otherwise.

Secretary **BAKER**. Well, Senator Wirth, your comments are well taken, and I would also point out, along the lines that you noted about what happened in 1980, that we came very close in 1983, as a matter of fact, but we got hung up at the very last minute.

So it is not something that I do not have an appreciation for. It is just that some people, quite frankly, interpret the idea of a summit—particularly one involving the President of the United States—as meaning that the question of tax increase is on the table, and he simply cannot participate in one if that is the interpretation. And I know you understand that.

Senator WIRTH. Well, I think everybody is going to have to give and get involved.

Chairman CHILES. Well, we have been very careful not to say "dead on arrival." We would hope that the other side would be careful not to narrow the table so much that we would never get around it.

Senator WIRTH. At least let us get to the table, I think, and not worry about the shape.

TAX REFORM BILL WINDFALL

Concerning the tax bill, I recall that for fiscal year 1987 there was a projected windfall from the new tax reform bill of some $11 billion, and that there was then to be a revenue loss in fiscal year 1998 of $17 billion. Are those still figures that you all are projecting?

Secretary BAKER. No; the figure that we are projecting is a revenue loss for fiscal 1988 of $800 million, which compares with CBO's most recent projection of a revenue loss of $4 billion. So there is not a great deal of difference there, Senator. There would be a great deal of difference if you looked at our most current estimate and compared it to the Joint Tax Committee estimate way back in September. That is comparing——

Senator WIRTH. Why has there been that figure? Is that where the 17——

Secretary BAKER. Well, partly because we have figures on actual economic performance for more than a full quarter since the JTC estimates were made and economic assumptions have changed, both CBO assumptions and Office of Tax Policy at Treasury assumptions.

My point is that the two most recent estimates of the revenue effect of tax reform in fiscal 1988 are ours as of January 5, 1987, and CBO's as of January 7, 1987; and there is only $3 billion difference between the two.

ENERGY IMPACT FEE AND PRICING

Senator WIRTH. Let me turn to a third issue, and that is where we may be headed in the country related to energy.

As you are more than familiar, our imports are creeping up; our domestic production appears to be declining. Stripper production, as you know, is way off, and a variety of other elements in terms of what we used to do in energy are dropping off: conservation, solar energy, alternative energy sources and so on. As an energy strategy, we seem to be backing away, I think, from commitments that we have historically made.

There are many who argue that as this happens, we are making ourselves increasingly vulnerable to another oil shock that would be even more dramatic than the two that we suffered a decade ago, and would argue that one of the ways in which we might be able to buffer ourselves against this would be to consider an oil import fee, would be to consider more realistic pricing in terms of gasoline, of other energy products.

Do you have any views, one, overall on the energy situation and pricing; and, second, on the specifics of an oil import fee and whether we should be pursuing that as part of these budget deliberations?

Secretary BAKER. Well, on the question of energy pricing generally, I would note, as you undoubtedly have, that the price of oil over recent weeks has come up some and is roughly in the $18-per-barrel range now.

In terms of maintaining a viable domestic energy industry as a matter of national security—and I happen to believe it is a matter of national security that we have a viable domestic energy industry—we are in better shape, obviously, at $18 than we were at $9 a barrel.

With respect to an oil import fee, as you know, the President considered the merits and demerits of that last year. He concluded that it was the equivalent of a new tax. He concluded that if we are talking about making America competitive, we ought not to increase the energy costs that American manufacturing companies, petro-chemical companies, and others, would have to bear versus the costs that would be borne by their competitors purchasing oil elsewhere and not facing any such import fee.

He concluded that the administration of such an import fee would require the creation of a bureaucracy, much of which we have just been able to dismantle since we decontrolled the price of oil. It would require that we reinstall a bureaucracy in the Department of Energy just to administer it. So he came down against it.

Would it help mitigate the obvious greater dependence that we are going to have on foreign oil? Yes, it would. And would it have a beneficial effect on our trade deficit? Yes, it would because I assume that the fee would come right to us at the Treasury. So there are some strong arguments for it; there are some strong arguments against it. The President, on balance, came down against it.

I have no reason to think that his mind has changed in that regard.

Senator WIRTH. Thank you, Mr. Secretary.

Chairman CHILES. Senator Kasten.

Senator KASTEN. Thank you, Mr. Chairman.

Mr. Secretary, I look forward to working with you over this next year. As a number of the members of the committee have done, I would like to congratulate you on the terrific job that you are doing.

EFFECT OF PHASING-IN LOWER TAX RATES

A number of people here have commented on the fact that the economy seems to be fragile at this time. Senator Wirth was just talking about the effects of tax increases and revenues.

Would you comment, first of all, on any impact which the delay in phasing in the lower tax rates is having on investments, on various efforts that you are making with your forecasters? I mean, how many people are sitting there delaying decisions until next year?

And do you have any ideas now as to what the effect of this next 2½ years of basic uncertainty is going to be as different kinds of tax changes take place as we fold in the tax cut which we voted for along with the tax simplification?

Secretary **BAKER**. Senator Kasten, we do not have any study that I am aware of that would quantify the effects. I think it is fair to say, as we said in testimony at the time tax reform was moving through both Houses of the Congress, that there will be some short-term adjustments in 1987 to what is a rather comprehensive and historic reform of our tax system.

There will be adjustments, as a consequence, of phasing these tax rates in. I cannot quantify those adjustments for you right now. As I indicated earlier, perhaps before you came in, I think one of the reasons that we see a larger November trade deficit for the United States is because people were anxious to buy before the deduction for sales taxes paid was eliminated.

I think you will see those kinds of things, but I cannot quantify those for you now.

QUICK TAX CUT IMPLEMENTATION GOOD FOR ECONOMY

Senator **KASTEN**. Let me try to ask the question the opposite way then; thinking about the dynamic effects of the tax cut. Going back to when Bill Steiger and a number of us reduced the rates on capital gains, revenues went up. We reduced the rates in 1981 on unearned income; revenues went up.

We are in a position now where we are in the process of putting in some simplification and some rate reductions in certain areas. Revenues are likely to go up once we get this all phased in.

Secretary **BAKER**. I understand. Let me answer it this way by saying that I quite agree with you that tax reform will have a very beneficial effect on the economy in terms of increased economic activity and greater revenues.

We measured that again during the time the tax reform was being debated in the Congress at roughly two to three-tenths of 1 percentage point of GNP each year for the next 10 years in increased growth of real gross national product. However, I don't know that we can say that 1987 is going to see that. In fact, we may see the reverse because people will be waiting, as you are pointing out, for those rates to become fully all the way down—as far down as they are going to come.

On the other hand, there was probably increased activity at the end of 1986 in the area of capital gains, people seeking to take advantage of a 20 percent capital gains rate which will go to 28 percent when tax reform is finally phased in. So there has probably been some increased activity in 1986 as a consequence of the fact that tax reform is coming.

Senator **Kasten**. Because cars and durable goods and things like that might have been going up because of the sales tax question?

Secretary **Baker**. They could.

Senator **Kasten**. What I am worried about is that we are going to be in a position—we have seen some of this discussion already in which people are going to say we want to delay the tax cut further; that the way we can deal with our deficit problem and increase revenues, if you will, without increasing taxes is simply make a few little adjustments here and delay the time in which the tax reductions will take place, either all or in part.

If that happens, I think we are going to be in terrible shape with even more of this kind of activity. And I am afraid that some of us that support the tax reduction taking place when the bill is fully implemented frankly would have liked to have the tax rates and deductions taking place at the same time in January, this January, are not going to have the kind of economic information on our side showing how important it is that tax cut takes place right now. There will be positive dynamic revenue effect and the growth aspect of the tax reform.

Are you concerned that as you see people talking about delaying the tax rate reduction?

TAX CUT DELAY NOT LIKELY

Secretary **Baker**. I am not concerned about a lack of economic information, Senator Kasten, primarily, I suppose, because for political reasons I'm really not concerned about any delay in the reductions really happening. I really don't believe, being very frank and candid, that there is two-thirds majority in both Houses up here to delay the tax-rate reductions, and there would have to be. The President has made himself very clear on that. So I frankly don't see it happening politically.

Senator **Kasten**. Thank you, Mr. Chairman.

Chairman **Chiles**. Senator Exon.

Senator **Exon**. Mr. Chairman, thank you very much. Welcome, Mr. Secretary; we are delighted to have you here.

We are making some progress, I think, quite obviously, although there has been a determined effort here by the Chairman and others to declare the President's budget not dead on arrival. That is a nice way of putting it.

THE PRESIDENT'S BUDGET

The facts of the matter are—and if anyone around this table is thinking otherwise, then they are not being realistic because the budget that the President has sent up here, in my opinion, and maybe in my opinion only, has no chance whatsoever of being accepted. And now we have taken care of the niceties, and I want to simply say that the budget is an extremely important document, and I just want to second the comments by others who suggested that we have some kind of a summit with the President. I don't think there should be any conditions connected with it. I think no one would go into that with the idea that we are going to do this or we are going to do that.

The problem is that the President's budget, whatever you call it, is not a budget that I think is going to pass the Congress. And as we make the changes, I wish we could get together at a very high level and try and get that worked out.

I also am delighted to see that there are talks of freezes and modified freezes. There are talks of sale of assets. All of those things I have agreed with and advanced in the past. I think the record will show, though, that when we talked about a freeze 4 or 5 years ago, which if we had put into effect, we may not have needed the Gramm-Rudman, we got only five votes, and three of the votes were down at that end of the table over there.

Also with regard to sale of assets, I think that got four votes, if I remember right, on the committee. Now it's a centerpiece of balancing the budget. I endorse that idea, but I do not endorse the idea that I believe Senator Lautenberg and others have come up with that selling petroleum assets is the same thing as smart privatizing, to use a new buzz word, because when we sell those assets, then they are gone forever. That is part of our national security, and I think that's a very bad proposition. Let me get into a question or two.

FARM CREDIT SYSTEM

Tell me what you think—and some of my colleagues have also gone into the serious agricultural problem that we have in rural America—tell me what you believe will be the role of you and your department in fiscal years 1987 and 1988 with regard to the Farm Credit System that you know is in serious financial shape today.

Secretary **Baker**. Well, we worked closely with the Farm Credit System, as you know, Senator Exon, and I think maybe you and I had some discussions at the beginning of the process when we restructured the Farm Credit System.

The Farm Credit System is very, very anxious to make it on its own. They now have a call on the U.S. Treasury, as you know, and I think they are going to do everything in their power to keep from exercising that call, including the pooling of assets to the extent that the courts will let them do so.

Senator **Exon**. You are also familiar with the fact that some of the Farm Credit Systems are now going into court to stop some of that pooling?

Secretary **Baker**. Yes; I say to the extent the courts will let them do that; that's why I said that. I understand there's a constitutional challenge, and assuming that challenge is defeated, which we think it will be, I think they will pool their assets so that they won't have to call on the Treasury. But we will continue to work closely with the Farm Credit System officials to make certain that the Farm Credit System survives, and survives in a very viable way.

SOLVENCY OF RURAL COMMERCIAL BANKS

Senator **Exon**. Mr. Secretary, what is your prediction with regard to the commercial bank system, particularly in rural America? As you know, we have had 2-record years of failures, and there are some predictions that there may be even more this year. Are you more optimistic than that?

Secretary **Baker**. I think that there is an underlying strength in the banking system generally throughout the United States so that we should not have undue concern, Senator, for the health of the U.S. banking system.

Just briefly, with respect to one of the bigger problems of the system. Namely, Third World debt, U.S. banks are in much better shape today than they were in 1982 when this problem came on us.

Yes, you are quite right that there are banks in agricultural and energy sectors in our economy that are having some problems. And we had more bank failures last year than we have had before since we instituted deposit insurance in the 1930's. But, in terms of any systemic threat to the United States banking system, it's not there.

WALL STREET "PAC MEN"

Senator **Exon**. Mr. Secretary, let me go to another very important matter that has not been discussed that I want your feelings on, and that is with regard to what is going on on Wall Street today. I refer to them as the Pac Men that are, in my opinion, providing nothing for the good of America as they eat up other corporations.

A typical case recently, as you are familiar with, is Goodyear where eventually the Goodyear Corporation had to raise, I think, $70 or $80 million to buy off a foreign raider to keep that corporation American-owned.

What, if anything, do you think you should do as Secretary of the Treasury about this, or should we let the "free enterprise system," of which I think green mail is not a proper part, run its own course?

Secretary **Baker**. I think it is incumbent upon both the Executive and legislative branches of the Government in the aftermath of the Boesky affair, Senator, to take another look at these issues. We looked at them a year and a half ago, and we concluded that, in our view, legislation was not necessary. That doesn't mean that we blessed each and every practice or procedure that's taking place out there now. We did not feel that there should be legislation outlawing, for instance, junk bonds.

It's our view today that we don't see an undue threat in terms of the quality of debt—overall debt in the system. But we should reexamine these issues in the light of what's happened. It's hard, though, to make policy determinations and policy judgments in this area, in my opinion, until we know the full story, and we don't know the full story now. The SEC has a number of investigations that are still ongoing, and it's extremely difficult, I think, to reach policy conclusions until you know what other shoes are going to drop.

We have initiated a review of these issues in our Economic Policy Council, and that review is currently underway.

Senator **Exon**. My time is up. Do you think we should maybe check into this with some congressional information carrying out our oversight responsibilities in this area?

Secretary **Baker**. Well, if you are talking now about the question of insider trading or you're——

Senator **Exon**. I am talking about Pac Men——

Secretary **Baker**. The whole thing?

Senator **Exon** [continuing]. And all these people that are eating up things.

Secretary **Baker**. I think that would be, in my view, far better than a rush to judgment and passing some legislation that we might subsequently find out was really not needed.

USER FEES

Chairman **Chiles**. According to the New York Times, we had about $150 to $175 billion worth of mergers last year.

Wouldn't it be kind of consistent with the administration's policy on user fees if we put a little user fee on the mergers? [Laughter.]

I think it is about $1.5 billion. If we have somebody pay a user fee for his FHA home, why don't we have Mr. Boesky and these other people pay a little user fee on a merger? That is not a tax.

Secretary **Baker**. We are not suggesting user fees on private transactions, Mr. Chairman. We're suggesting user fees on federally furnished services.

Chairman **Chiles**. Well, I am talking about this user fee to help fund the Antitrust Division.

Secretary **Baker**. You mean to fund the SEC?

Chairman **Chiles**. Sure.

Secretary **Baker**. The SEC is moving more and more toward user fees, and to the extent that this kind of activity requires more supervisory activity on the part of the SEC, I don't think we would have any problem with that.

Senator Domenici.

Senator **Domenici**. Thank you, Mr. Chairman.

ACTION NEEDED ON THREATENED COMPANY TAKEOVERS

Mr. Secretary, frankly, I am glad that you said maybe you ought to look at the Wall Street scene and the merger scene. I hope it isn't limited to the insider problems and the criminal activities. Frankly, I just can't believe that we haven't gone way too much in one direction in terms of the current status of prerogatives between outsiders and management. We tried to get management to be more responsive, but it does seem to me that what we have got now is cannibalism. I mean we have got a threat that never takes over, but it wrecks the company that's threatened. I mean it's about 20 to 1, 20 are wrecked with debt for the 1 that is taken over.

I think that requires you all to do something. Congress can look at that forever, but unless the executive branch looks, nothing really will get done except a lot of noise.

Secretary **Baker**. Well, I don't disagree with at all, Senator, and we are taking a close look at it.

And I might also say with regard to competitiveness in America, we have such a preoccupation with short-term performance that you don't see, quite frankly, with respect to some of our competitors. It's that kind of thing, we think, which ought too be closely looked at.

Senator **Domenici**. That is what I was just going to say. It just appears to me that you aren't going to have any investment by American companies in such things as long-term research and development when to acquire some kind of surplus puts them immediately—they are just sitting there waiting for Boone, T. Boone, or whatever his name is, my former good friend. Since I introduced the junk bond bill, he's not my friend any more.

But basically they just sit around and prey on them, you know, and they can't keep any of that money around. And either we are going to have to do it by way of spending Federal money or we are going to have to encourage our companies to have long-term money around for that kind of thing.

Having said that, let me dispel a couple of things.

ABOLISH OLD PROGRAMS FOR NEW

Mr. Secretary, if you've read anywhere that I think we need to spend more money rather than less on domestic programs, I hope you understand that what I have really said is that I think we have an inventory of programs on the books that are extremely outdated in comparison with some new problems. I believe we ought to get rid of some of the old ones in deference to some new social problems, such as homelessness and mentally ill who are walking the streets because we were so civil that we turned them out of institutions, and probably rightly so, and now we don't know what to do about it.

But I don't believe we have to spend a lot of new money. I think we ought to see whether the Economic Development Administration at $300 or $400 million is as important as some of these new problems. So I just hope that if you read about that, you understand where your friend from Mew Mexico is coming from.

TWO-YEAR BUDGETING

Let me ask you a question with reference to 2-year budgeting and 2-year appropriations. I understand the White House is very supportive and has submitted to the Congress in this budget a 2-year budget for defense. Now, that really doesn't mean that Congress has decided to appropriate for 2 years yet.

You know, you have given us a 2-year budget, but we only appropriate 1 year at a time.

I have come to the conclusion that that's ridiculous; that we waste an inordinate amount of time every year. They claim it's the budget problem. I believe it is the whole fiscal process.

Why do we have to appropriate every year when it's about 90 percent the same thing?

Do you know whether the President would support 2-year appropriations on defense? And if the answer to that is yes, would he support 2-year appropriations for all domestic appropriated accounts?

Secretary **Baker**. I don't know the answer to that, Senator. And, of course, that is not really my area of responsibility or expertise. But let me just give you off the top of my head my own view. It would seem to me that it makes sense, particularly if you are going to go to a 2-year cycle as far as the budget itself is concerned. It then would be consistent to go to a 2-year appropriations cycle. But I'm sorry, I can't tell you specifically what his view on it would be.

Senator **Domenici**. I'm going to tell you another reason that I think it's imperative. There's a lot of talk about getting together with the President. I think that's admirable. I tried it a couple of times. I hope my friend, Senator Chiles, has more success than I did in terms of trying to get this done, although we came very close. We didn't choose to call it a summit. From my standpoint, we have got to drop that word and call it something else. That sounds like a debating society with the President of the United States, and you are not going to do that. Forget that. He won't do that; you wouldn't advise him to.

But it seems to me that we need some mechanism to give the President of the United States a lot more assurance of what the budget will look like over a span of longer than 1 year. This implies that we as a Congress have made some commitments that we are going to live up to, both on the size of the defense and the size of the rest of Government. And I say to you in that respect it appears to me that if we are ready to go with 2 years at a time, it makes a significant difference to talk about where we really are and what we have really done. How much have we accomplished?

Can I ask, without any commitment on your part, whether you think what I have just said makes some degree of sense?

Secretary **Baker**. Well, yes, I think it does, Senator, and that's the reason I said as far as I'm personally concerned, I think I would favor a 2-year cycle.

You know, the President feels that he really did not get the benefit of an understanding, and I can't remember what the year was, back there in 1981 or 1982, in the form of legislated spending cuts. It was 1982 as I can remember against——

Senator **Domenici**. TEFRA I.

Secretary **Baker**. TEFRA, sure.

So anything that could increase the certainty that there would be action and also that such action would stick and not be undone would be beneficial.

Senator **Domenici**. Now, I do want to say in a more serious vein to my friend, Senator Chiles, and those who have been asking and talking about getting together and trying to come up some master plan, frankly I believe we have to get on a little bit with where we are moving and what we are thinking about. But ultimately it seems to me like an excellent idea, and I didn't want to leave the impression that I was not in favor of it.

NATIONAL PETROLEUM RESERVE

On the Naval Petroleum Reserve, just a comment. I don't know how many of these assets we should sell and how much we should count on them for this fiscal restraint. But let me suggest the Naval Petroleum Reserve ought to be really looked at. Some people think we ought to keep it there because it's for our security.

As a matter of fact, none other than the GAO has said it's about as poorly run an operation as anything in Government. I mean we are selling out of that reserve without regard to the marketplace. We have, for more than 1 year, sold it at a third below market price because we got government stuck into some format. I would think it is worth looking at.

If we are worried about petroleum security, maybe we ought to look at selling it and in some way tying the sale to the strategic petroleum reserve that we are buying. Instead of trying to make Government a better businessman, maybe we ought to get out of the business altogether.

Secretary BAKER. Could I just volunteer a second to that, Mr. Chairman, because, it seems to me and recognizing what Senator Exon said, if we needed to get that back, we could get it back, Senator; we could condemn it, and it wouldn't be any problem at all.

But the fact of the matter is——

Senator EXON. That's the free enterprise system at work. [Laughter.]

Secretary BAKER. Well, we would turn it over to the free enterprise system, and if we needed it for some national security reason, we could get it back. But the fact of the matter is we now have a strategic petroleum reserve. And it really doesn't make any sense for the Federal Government to be in the business of producing oil.

Chairman CHILES. We weren't filling it pretty well while we had a chance to buy some cheap oil.

Secretary BAKER. Well, we increased the fill rate a little bit during that period.

Chairman CHILES. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

TRADE IMBALANCE LARGE EVEN WITH DEVALUED DOLLAR

Mr. Secretary, I want to welcome you here this morning and say to you that your predecessors, when we would discuss with them the problem of the overvalued dollar sometime ago, would throw up their hands and indicate that there's nothing that could be done about it. But I think, to your credit, you have done an excellent job of addressing the problem of what, in my judgment, was a grossly overvalued, American dollar in world markets up to 1985.

Now, there was much talk that if the dollar could be brought down to reasonable, more reasonable valuation in conjunction with other currencies, that this would have a very salutary effect on remedying our trade deficit. And we have seen since the first quarter of 1985, and through the second quarter of 1986, a decline of slightly over 26 percent in the value of the dollar, according to the figures that I have here. Yet, we see the unfavorable balance of trade issue looming even more dangerous. 1986 was the year in which many analysts expected a turnaround in the trade deficit to occur. But, quite the contrary, the latest figures that we have seen indicate that the trade deficit is becoming even more gargantuan, even more threatening and more dangerous.

My question to you is, What has happened here? Why are prices of foreign goods, not going up here in our domestic market as a result of our declining dollar?

FOREIGN EXPORTERS TO U.S. CAUSE TAXING LOSS

Secretary BAKER. They are not going up as much as might be expected, Senator Sasser, because the exporters to the United States are eating the differential. Their margins have been squeezed as a consequence of the exchange rate changes, but they can't continue to do that forever.

Now, why haven't we seen more results from the exchange rate changes with respect to the trade deficit? Besides the failure of prices of imported goods to move with the exchange rate, I think probably because in general it takes quite a while before you see exchange rate changes translated into the trade deficit.

Also I would say to you, as we have all along said, that the exchange rate is not the sole answer. We've said all along you can't do this just on the exchange rate side alone.

I do think that the results of August, September and October, the declines that we saw in our trade deficit for those months, are very, very encouraging in terms of whether or not we are beginning to turn the corner.

I have already mentioned that I am quite aware that we zoomed up to $19 billion in November, but I think that there were some special circumstances, which will probably appertain as well in December—end of the year type stuff.

I really do believe that we will see some beneficial results from these exchange rate changes in due course. The economists tell us it takes 12 to 18 months for movements of exchange rates to impact the trade deficit. We are only about 15 months now, I think it is, away from the Plaza Agreement of September 1985.

Senator **Sasser**. Well, I hope we soon see some benefit from them. But I am beginning to despair that we are not going to see the significant benefit that we had hoped for. In other words, we see, for example, in Japanese automobiles, Japanese auto manufacturers have eaten about all the profit margin they can eat now, and Japanese automobile prices have stabilized and even gone up. Yet, they continue to find a ready buyer for every car they export into the United States.

I think what we are seeing here is not just price differentials but also quality differentials.

Secretary **Baker**. I don't disagree with that.

COMPETITIVENESS OF AMERICAN PRODUCTS

Senator **Sasser**. I think that says something very significant about the competitiveness of American products and what we are seeing coming out of our manufacturing facilities.

Now, as a corollary to that, we are also witnessing an undeniable employment shift occurring in this country from the manufacturing sector to the service sector. And this has resulted, as you know, in a proliferation of low paying jobs.

Now, there has been much breast-beating about the great number of jobs that have been created in the last few years. However, a recent Joint Economic Committee study shows that clearly 58 percent of all the new net employment between 1979 and 1984 paid annual wages of less than $7,000 in constant 1984 dollars.

The report concludes that, and I quote, "The strong and apparently enviable record of job creation since 1979 masked the fact that more than 3.1 million of the 8 million net new jobs represented additional low-wage employment over and above the number of low-wage jobs that would have been created under earlier conditions.

MIDDLE CLASS IN DANGER

And what we are saying, and we know this, is auto workers and steelworkers and other assembly line workers are ending up waiting tables and pressing trousers in a dry cleaning establishment, or working in McDonald's. The authors of this study conclude that the "continuing decline in high-wage manufacturing combined with expansion on the low-wage retail trade and service sector have led to the popular perception that America may be on the verge of losing its middle class."

Would you comment on this trend, Mr. Secretary?

Secretary **Baker**. Senator Sasser, I don't think it is correct to say that we are moving in the direction of a wholly service economy. Overall, there has been no erosion in the contribution of the manufacturing sector's contribution to total real GNP.

It's true that employment in manufacturing is down. It is down by about 10 percent of what its historic high was in 1979. In 1979, 21 million Americans were employed in manufacturing. That dipped to around 18 million during the 1982 recession. We are now back up to about 19 million.

MANUFACTURING NOT ERODING

But manufacturing as a percentage of real GNP is not eroding. Now, I know it is fashionable to say we are going to become a Nation of people selling hamburgers to each other. But I really don't think that the facts support that, acknowledging all the while that employment in manufacturing is down, and is down by roughly 2 million from its historic high in 1979. That shows, I think, that in the manufacturing sector, Mr. Chairman, we are doing a pretty good job with respect to productivity. We are getting a little leaner and a little meaner. But, overall for the entire economy we are not doing a very good job.

Chairman **Chiles**. Well, my understanding is of that 8 million new jobs we created in the last 5 years, over half of those, about 60 percent, are $7,000 a year jobs. That is a heck of a bad figure, terrible statistics, and certainly shows that we are going to the service jobs.

Secretary **Baker**. Jobs, yes, sir, I would agree.

In terms of the manufacturing sector's contribution to overall productivity, I would disagree. We are down 2 million jobs in the manufacturing sector from the absolute high in 1979, but we are up 1 million from the low in 1982. If you would like, Senator Sasser, we can send you all this data.

LOSS OF REVENUE ADDS TO DEFICIT

Senator **Sasser**. I would like to see it, Mr. Secretary. And I just wanted to make this closing remark, Mr. Chairman.

We are experiencing a proliferation in low-wage employment. And I think in the long term that will have a very detrimental effect on the budget deficit because the explosion in low-wage jobs means that these folks are not paying the same amount of taxes into the Treasury as before. When you are slinging hash and making 6,000 bucks a year, you are not carrying the same tax burden as you did when you were a $22,000 a year steelworker.

Secretary **Baker**. To say that there is an explosion in low-wage jobs is not the same as saying that explosion replaces-high wage jobs. I don't think it is.

I acknowledge to you that we're down 2 million from the historic high in manufacturing employment, but we are up a million in high-wage jobs, manufacturing sector jobs, if you will, from 1982. So on top of that, we have a lot more net new jobs outside manufacturing. A lot of them are low paying, but they are new jobs.

[The following was subsequently supplied for the record by the Treasury Department:]

Question from Senator Sasser:

"A recent Joint Economic Committee study shows that nearly 58 percent of all the new net employment between 1979 and 1984 paid annual wages of less than $7,000 . . . The authors conclude of this study that the continuing decline in high-wage manufacturing combined with expansion on the low-wage retail trade and service sector have led to the popular perception that America may be on the verge of losing its middle class.

"Would you comment on this trend, Mr. Secretary?"

Response. The JEC study addresses a very important topic. Without question, one of our crucial policy concerns is to ensure that the standard of living of the American worker is not jeopardized during this period of rapid change in the number, and the mix, of jobs. Fortunately, many of the pessimistic conclusions drawn on the basis of the Committee report appear to be incorrect or exaggerated.

It is so easy to be confused by the report's focus on the concept of "net new jobs." For example, the report indicates that between 1979 and 1984 almost 97 percent of the net new employment of white males was in the low-wage stratum (below $7,000 per year). To the casual reader, this suggests that almost all newly hired white men are accepting jobs at or below the Federal minimum wage. But as the JEC report itself notes, the actual share of low-wage jobs increased by less than three percentage points during those five years, to 22.7 percent of all while male employees. Meanwhile, the share of jobs in the middle wage stratum actually increased, indicating no shrinking in the "middle class," at least among white males. The explanation is that computed net job shares are very sensitive to small movements in the aggregate job market, and can give an extremely distorted picture of favorable or unfavorable trends.

A second potentially misleading aspect of the Committee study is that it counts as a "job" any individual aged 16 or over reporting wage and salary income during the sample year. This includes part-time and temporary workers as well as full-year forty-hour-per-week employees. For example, a college student working in the summer will be counted as a "low-wage job" so long as he earns less than $7,000 during the year, even though he may have been earning up to a $28,000 annual rate during the 3 summer months. When we look at full-time, year-round workers, only 6 percent are counted as low-wage in 1984, even using the JEC's definition and computational procedures.

Perhaps the most telling criticism is that, even if one accepts the net job focus and the unusual job definition mentioned above, the results virtually disappear when an alternative measure of inflation is used. The study's results are very dependent on the particular price index used to deflate income changes over the study period. The Consumer Price Index has been rightly criticized for its overemphasis on house prices, and consequent exaggeration of inflation, prior to the change in CPI methodology in 1983. This change was introduced by the Labor Department after exhaustive analysis and consultation with the academic community. The authors of the JEC study found that when they substituted the Commerce Department's arguably more accurate Personal Consumption Expenditures deflator as an inflation measure, the share of low-wage jobs was estimated to increase by only 0.5 percentage points between 1979 and 1984, and to decrease between 1973 and 1984. That is, use of the alternative deflator essentially erases the study's evidence of long-term real wage decline.

The foregoing comments all involve statistical or methodological issues which lead us to believe that the study's results have been exaggerated or misinterpreted. I would also like to call your attention to other related work which calls into question some of the conclusions in the report. Researchers at the Bureau of Labor Statistics, using much the same date as the JEC study, have found that there has been no noticeable movement into low-wage occupations in recent years, despite the shift away from manufacturing industries and toward service industries. It is true that the progress in real wage growth has been relatively slow, but this has primarily been the result of changes in the wage distribution within occupations. That is, the evidence is not that the occupational mix is deteriorating, say by a substitution of short-order cooks for skilled craft workers. In fact, when occupations are categorized as "high," "middle," or "low" wage, there appears to be a continuing, long-term movement out of the lowest group and into the highest.

A number of explanations have been offered for the sluggishness in real annual earnings. Basically, these are the same factors used to explain the so-called "productivity slowdown." For example, average employee experience or seniority may be falling, due to the depressing effects of the large baby-boom cohort, the entry of large numbers of women into the labor force, and so on. Some of these demographic trends can be expected to reverse in future years, leading to more favorable movements in average wages within particular job classifications. The important point here is that we have no real basis for concluding that the trend toward employment in service industries has led to any polarization of the work force, or to a "low-wage economy."

Chairman CHILES. Senator Dodd.

Senator DODD. I want to go on to something else.

Chairman CHILES. Go ahead.

BUDGET SUMMIT WITH PRESIDENT

Senator DODD. First of all, let me join the chorus of praise for you, Mr. Secretary. I think you have done an excellent job in a number of areas. People talk about the dollar, but I think in areas of trade, the GATT and a number of other things, I think your initiatives have shown some real creativity and real movement which we did not have for a couple of years, a number of years, until you got into the position you are in.

The summit, as I read what you are responding to, it is a sense of timing. You do not want to create the precedent of a summit every time there is a budget sent up here, but you are not opposed to the notion if things get into gridlock is how I read your kind of response to the questions about a budget summit. Am I misreading your reaction to that kind of request? It is not something you are opposed to, but if its going to occur, it ought to occur in a timely fashion when everything else has failed, is how I read you.

Secretary BAKER. Well, it is not just, I think, a matter of timing, Senator Dodd. In the first place—and the chairman, I think, knows my views on this—I agree with Senator Domenici about the use of the term "summit." That is number one.

Secondly, it is not my view that these kinds of things are best accomplished publicly. We have a lot of private meetings, and we have a lot of public meetings up here. Sometimes it is more difficult to accomplish things publicly than it is to accomplish things privately. In the end, they are all going to have to be ratified, adopted, approved publicly.

Senator DODD. OK. I read you.

TAX REFORM REVENUE LOSS

Senator Wirth asked about the joint tax figures. As I understand it, they are still holding to that $17 billion figure. I may be wrong on that, but I understood that they still cling to that number, that that is the revenue loss in this coming year.

Secretary **Baker**. Yes.

Senator **Dodd**. And I heard you very clearly that Treasury has an entirely different answer to that question. Could we ask you to give us some of the details and the calculations on how you have arrived at the number you have? Since we have the Joint Tax Committee, I would just be curious about it.

Secretary **Baker**. Sure, I will be glad to.[1]

Let me say I realize the Joint Tax Committee is holding to that. That estimate was released on September 18, 1986.

Senator **Dodd**. I recall that, yes.

Secretary **Baker**. I think more meaningful than what an old estimate of the JCT might be is what CBO's new estimate, taken at the same time as our new estimate, is, and we are within $3 billion of each other.

Senator **Dodd**. I would like to just look at those three.

Secretary **Baker**. Sure. We will get that.

ESTABLISH INTER-BRANCH BUDGET GROUP

Senator **Dodd**. In that regard, you know, the notion was at some point that we had sort of objective economic information by which we all sort of worked on, I think, over the years. And I do not mean in the last 5 or 6; I think it goes back a lot longer than that. These numbers have become more political numbers in many ways. At least that is the perception of an awful lot of people. We get such disparity from time to time.

What is your reaction to trying to come up with some sort of a standardized set of assumptions we work on, whether you have people appointed by the Office of Management and Budget, CBO or others, but at least we begin to work with a set of assumptions on which the executive branch and the Congress are in basic agreement. We may be both wrong at the end of the year, but at least we begin on that rather than as we go through this process year in and year out of beginning miles apart from each other—which causes, it seems to me, the process to fall apart even before we start, in many ways.

Do you have any reaction to that?

Secretary **Baker**. Well, I think that would be probably good if we could ever get there, but it is going to be extremely difficult, I think, from a practical standpoint, and it may be difficult from a legal standpoint. I do not know how the separation of powers fits into this, but it would seem to me that there are some difficult issues to be resolved. Who is going to control that estimating body? Who is going to appoint it? Who is going to have the power to remove it? You get back to some of the same questions that you had with Gramm-Rudman-Hollings, and the Supreme Court declared a portion of that unconstitutional. I think it may present the same sort of problem.

Senator **Dodd**. It would be worth looking at, though.

Secretary **Baker**. Yes, sir. I do not have any argument with that.

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[1] See p. 152.

THIRD WORLD DEBT

Senator **Dodd**. And, lastly, you have covered an awful lot of ground here with other questions. The Third World debt issue—which I do not if we have gone into in great detail here at all today, but obviously there is a strong relationship there in the deficit picture. I commend you for the Baker Plan. I have some problems with it, but I think it is a strong initiative. And the idea that we are not just calling upon these Third World countries to just tighten their belts, recognizing the problem there, but expanding economies is a new twist that was added a few years ago which you raised, and I commend you for it.

Senator Bradley has raised as well a proposal. His talks about bank forgiveness along with the fresh credits, the $29 billion I think you talk about in your plan. I agree with you about your assessment of his—at least on the point that bank forgiveness, as appealing as it may be to Alan Garcia in Peru and elsewhere, that we have got to keep the banks involved in this. And if you have a bank forgiveness plan, my view would be that they would get out of it future involvement, and that could be more devastating for these countries than anything else.

My problem with your side is that I think you are too restrictive in terms of what you expect these countries to do politically. There is only so much they can do, such little elasticity. A lot of them are just fresh democracies, barely a year old in some cases. And to ask them to do things which we can get along with—although you see the difficulty we have in a 200-year-old democracy, a strong Nation. No one talks about any kind of political unrest in this nation. In these other nations, that kind of activity can create real tension and could disrupt what I think is a very positive set of circumstances in many of these countries.

How restrictive do you think you ought to be in that, and how much of a consideration do you place on the political?

NO MAGIC FORMULA FOR DEBT SOLVING

Secretary **Baker**. Well, I think the politics of it are extremely important, and that is one reason that we have gone to growth as a basis for the solution to the debt problem in lieu of austerity. Politically, we have gotten to the point, as far as austerity is concerned, that those countries could not sustain it any more, and many of them were at risk of losing a democratic form of government as a consequence.

Sure, it is hard for them. We are talking to them about privatization, but it is hard for us to privatize the Naval Petroleum Reserves.

Senator **Dodd**. Or Amtrak.

Secretary **Baker**. Or Amtrak or a lot of other things. And we understand the politics of it. But we firmly believe, Senator Dodd, that the only way they are ever going to get back is to find a way to grow and to adopt the kind of free market policies that we adhere to and subscribe to here in this country.

It is a case of taking a look, again, on a case-by-case basis. That is why it is so important that we not delude ourselves into thinking that there is some magic formula solution to the debt problem which will work across the board.

Senator **Dodd**. That is my point, because Third World countries are not all alike.

Secretary **Baker**. No, sir.

Senator **Dodd**. There are substantial differences.

Secretary **Baker**. Some can do some things that others cannot do.

Senator **Dodd**. Free market economies in many Third World countries just do not make it, at least in the context, I think, many people read how we talk about in those. That is my point.

Secretary **Baker**. That is absolutely right, and that is why we should continue to deal with this problem on a caseby-case basis.

Senator **Dodd**. What is the plan? Are you sending that up? Are you sending up a plan on this, by the way, for us to consider with regard to Third World debt? Is there something you expect the Congress to be doing on this?

Secretary **Baker**. No, sir, we do not. We have our program for sustained growth. I think you are quite familiar with it. It does not require legislation, except it does require legislation in the area of funding the multilateral development banks, because they are integral to a solution to the problem.

Senator **Dodd**. I commend you for your comments on that point earlier, too, by the way.

[The following was subsequently supplied for the record by the Treasury Department:]

DEPARTMENT OF THE TREASURY
WASHINGTON

January 16, 1987

Dear Mr. Chairman:

The Administration's Fiscal Year 1988 budget to be submitted on January 28, 1987, will include the Treasury Department's estimates of the change in receipts due to enactment of the Tax Reform Act of 1986. The estimates, based on the Administration's latest macroeconomic forecast, include $18.5 billion of additional revenue (net of changes in outlays, principally the Earned Income Tax Credit) in Fiscal Year 1987, -$0.8 billion in Fiscal Year 1988, -$14.5 billion in Fiscal Year 1989, -$11.8 billion in Fiscal Year 1990, and -$7.1 billion in Fiscal Year 1991. The total budget effect of -$15.7 billion over the 5-year 1987-1991 period should be considered virtually revenue neutral, given that the Tax Reform Act contains provisions that raise nearly $600 billion over that period, and other provisions that cut nearly $600 billion. This -$15.7 billion represents less than one-half of one percent of the $5 trillion of budget receipts expected over the forecast period.

Enclosed for your information are the Treasury Department's detailed line-by-line revenue estimates of the Tax Reform Act of 1986 and a comparison of the Treasury and Congressional Budget Office tax reform revenue estimates. The Treasury estimates differ from the September 18, 1986 Joint Committee on Taxation estimates and the recent Congressional Budget Office estimates due to different macroeconomic forecasts, different responses in taxpayer behavior resulting from changes in certain provisions, and other technical differences, including reestimation of an ESOP/estate tax provision. We hope the detailed estimates are helpful in understanding the estimated change in total receipts due to enactment of the Tax Reform Act of 1986 included in the Administration's Fiscal Year 1988 Budget.

Sincerely,

O. Don Chapoton

O. Donaldson Chapoton
Deputy Assistant Secretary
(Tax Policy)

The Honorable Lloyd Bentsen
Chairman, Senate Finance Committee
United States Senate
Washington, DC 20510

Enclosures

Note--Identical letters were sent to Senator Packwood, Representative Rostenkowski, and Representative Duncan.

Comparison of Treasury Department and Congressional Budget Office Revenue Estimates
Of the Tax Reform Act of 1986
(P.L. 99-514)

		Fiscal Years					
		1987	1988	1989	1990	1991	Total, FY 1987 Through FY 1991
		($ Billions)					
I.	Department of the Treasury						
	Change in Tax Receipts	18.6	.9	-11.7	-9.0	-4.2	-5.4
Less:	Change in Outlays 1/	.1	1.7	2.8	2.8	2.9	10.3
Equals:	Change in Unified Budget Deficit	18.5	-.8	-14.5	-11.8	-7.1	-15.7
II.	Congressional Budget Office						
	Change in Tax Receipts	11.6	-1.7	-9.6	-1.3	3.7	2.7
Less:	Change in Outlays 1/	.1	1.8	3.1	3.3	3.5	11.8
Equals:	Change in Unified Budget Deficit	11.5	-3.5	-12.7	-4.6	.2	-9.1
III.	Net Difference: Treasury less Congressional Budget Office						
	Change in Tax Receipts	7.0	2.6	-2.1	-7.7	-7.9	-8.1
Less:	Change in Outlays 1/	*	-.1	-.3	-.5	-.6	-1.5
Equals:	Change in Unified Budget Deficit	7.0	2.7	-1.8	-7.2	-7.3	-6.6

Department of the Treasury
Office of Tax Analysis

January 8, 1987

* Less than $50 million.
Note: Details may not add to totals due to rounding.

1/ Predominately changes in the earned income tax credit; includes small changes in interest outlays.

TAX REFORM ACT OF 1986

(See Notes A And B At End Of Table)

	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-91 1/
	($ Millions)					
I. INDIVIDUAL INCOME TAX PROVISIONS						
A. Basic Rate Structure						
1. Tax rates of 15% and 28% (does not include capital gains)	-26011	-38149	-50926	-57676	-63745	-236507
2. Increase in standard deduction	-	-4433	-6449	-7004	-7566	-25452
3. Increase personal exemption to $2000 with phase out based on taxable income	-16406	-28592	-28188	-29259	-30287	-132732
=Revise treatment of the elderly and blind	485	781	1001	1268	1581	5116
=Disallow personal exemption by new dependent filers	65	196	194	194	194	843
4. Round down inflation adjustment to $50 multiple	0	0	204	932	1471	2607
5. Repeal two-earner deduction	1500	6018	6194	6670	7138	27520
6. Repeal income averaging	450	1731	1837	1979	2115	8112
7. Interaction among individual tax provisions	-314	421	858	934	397	2296
B. Revise earned income credit, Individual 2/						
Receipts	-	-356	-852	-1054	-1279	-3541
Outlays	-52	-1535	-2649	-2719	-2764	-9719
C. Exclusions from Income						
1. Repeal partial exclusion of unemployment compensation benefits	320	1045	984	945	920	4214
2. Scholarships and fellowships	57	209	273	288	296	1123
3. Limit present law exclusion for certain prizes and awards	*	2	2	2	2	8
D. Deductions for Personal Expenditures						
1. Itemized deduction for State and local sales taxes						
Individual	794	5185	4580	4555	4681	19795
Capitalization Rule for state and local taxes						
Individual	47	119	96	78	59	399
Corporate	488	738	603	521	351	2700
2. Medical expense deduction—Increase floor under such deductions to 7.5 percent of AGI	223	1504	1590	1599	1607	6523
3. Adoption expenses repealed 3/	1	2	2	2	2	9
4. Deductibility of mortgage interest and taxes allocable to certain housing allowances	*	*	*	*	*	*
E. Expenses for Business or Investment						
1. Meals, travel, and entertainment expenses						

	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-51 1/
	($ Millions)					
Restrict deduction of business meals expenses and business entertainment expenses to 80%						
Individual	367	625	700	784	857	3333
Corporate	888	1467	1615	1833	2022	7825
FICA and SECA	63	112	133	149	180	637
Limit deductions for luxury water travel						
Individual	1	3	3	3	3	13
Corporate	*	*	*	*	*	*
No deductions for educational travel						
Individual	4	13	14	14	14	59
Corporate	*	*	*	*	*	*
No deductions for investment seminars						
Individual	1	3	3	3	3	13
Corporate	*	*	*	*	*	*
Charitable Travel						
Individual	*	*	*	*	*	*
2. Employee business expenses, investment expenses and other miscellaneous itemized deductions subject to 2% floor	716	4781	4903	5354	5801	21555
3. Limit deductions for home office expenses and hobby losses						
Home office expenses, Individual	*	*	*	*	*	*
Hobby losses, Individual	*	*	*	*	*	*
F. Political Contributions Tax Credit Repealed	-	275	293	288	295	1151
SUBTOTAL						
Individual	-37700	-48617	-62684	-69101	-75441	-293543
Corporate	1376	2205	2218	2354	2373	10525
FICA and SECA	63	112	133	149	180	637
Outlays	-52	-1535	-2649	-2719	-2764	-9719
SUBTOTAL, INDIVIDUAL INCOME TAX PROVISIONS	-36313	-47836	-62982	-69317	-75652	-292100
II. CAPITAL COST PROVISIONS						
A. Cost Recovery: Depreciation; ITC; Finance Leases						
1. Depreciation and expensing						
Modify Accelerated Cost Recovery System						
Individual	-617	-1220	-594	421	1943	-67
Corporate	-1727	-2179	-786	1951	6068	3327
2. Regular Investment Tax Credit						
Repeal investment tax credit effective Jan. 1, 1986						
Individual	5249	5158	5656	6098	6801	28961
Corporate	19379	17867	21865	25304	28823	113237
Reduce ITC carryforwards and transition ITC's by 35%						
Individual	60	199	270	191	95	815
Corporate	252	1447	1624	1081	583	4987
3. Repeal finance lease rules effective January 1, 1987						

	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-91 1/
			($ Millions)			
Corporate	-	121	325	436	431	1313
Limit on Business Credits (75%)						
Individual	*	*	*	*	*	*
Corporate	984	385	251	148	85	1853
15 year carryback of unused ITC's for steel companies						
Corporate	0	-565	23	51	82	-409
15 year carryback of unused ITC's for farmers						
Individual	0	-234	0	18	30	-186
SUBTOTAL						
Individual	4692	3903	5332	6728	8869	29523
Corporate	18888	17076	23302	28971	36072	124308
SUBTOTAL, ACRS AND ITC	23580	20978	28634	35699	44941	153831
III. ACCOUNTING ISSUES						
A. Deny the Use of the Cash Method of Accounting by Financial Institutions (Including Finance Companies)						
Corporate	395	712	762	787	484	3140
B. Simplified Dollar Value LIFO Method for Certain Small Businesses						
Individual	0	-4	-9	-9	-7	-29
Corporate	-11	-124	-212	-191	-136	-674
C. Limit Use of the Installment Method						
Deny for sales under revolving credit plan, portion of sales by dealers in personal property, sales of publicly traded property						
Individual	19	50	36	36	37	178
Corporate	1271	1663	1345	1358	1395	7032
D. Uniform Capitalization Rules						
Require capitalizing both direct and indirect production costs for manufacturing, construction, and development						
Individual	280	643	679	680	653	2935
Corporate	5947	8246	7820	6992	6608	35613
E. Disallow Reserve Method for Bad Debts Other than Selected Financial Institutions						
Individual	32	95	91	92	92	402
Corporate	992	1536	1475	1489	1491	6983
F. Repeal Election to Deduct Qualified Discount Coupons						
Corporate	0	47	37	38	39	161
G. Solvent Taxpayers Required to Recognize Income from Cancellation of Indebtedness						
Individual	2	4	3	3	2	14

	Fiscal Year 1987	1988	1989	1990	1991	Totals, 1987-91 1/
			($ Millions)			
Corporate	57	79	62	52	43	293
H. Conform Taxable Years of Partnerships, S Corporations, and Personal Service Corporations to Owners						
Individual	0	536	370	377	278	1561
I. Public Utility Billing Rule						
Corporate	191	356	384	387	200	1518
J. Pre-1984 Rules for Depreciation Recapture - Installment Sales of Farm Irrigation Equipment						
Individual	*	*	*	*	*	*
Corporate	*	*	*	*	*	*
K. Contributions in Aid of Construction						
Corporate	66	126	152	177	201	722
SUBTOTAL						
Individual	333	1324	1170	1179	1055	5061
Corporate	8908	12641	11825	11089	10325	54788
SUBTOTAL, ACCOUNTING ISSUES	9241	13965	12995	12268	11380	59849
IV. CAPITAL GAINS						
A. Repeal Long-term Capital Gains Exclusion for Individuals						
Individual	12518	-1495	-59	3364	7442	21770
B. Corporate Capital Gains						
Alternate Capital Gain Rate of 34%	526	904	1034	1211	1250	4925
C. Liberalize Incentive Stock Options						
Individual	-**	-**	-**	-**	-**	-**
D. Straddles						
Individual	-	12	*	*	*	12
SUBTOTAL						
Individual	12518	-1483	-59	3364	7442	21782
Corporate	526	904	1034	1211	1250	4925
SUBTOTAL, CAPITAL GAINS	13044	-579	975	4575	8692	26707
V. COMPLIANCE AND ADMINISTRATION						
A. Increase Penalties						
Individual	49	279	376	384	393	1481
Corporate	28	76	110	112	115	441
Excise	1	8	9	10	10	38
Estate and Gift	0	5	7	7	7	26

	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-91 1/
			($ Millions)			
B. IRS Interest Provisions 2/						
Individual	34	98	177	258	351	918
Corporate	65	177	303	418	554	1517
Outlays	-35	-140	-144	-111	-114	-544
C. Information Reporting						
Individual	250	763	1081	1103	1157	4354
Corporate	0	70	5	5	5	85
D. Tax Shelters						
Individual	*	*	*	*	*	*
E. Estimated Payments						
1. By Individuals (90%)						
Individual	1580	-3	48	113	86	1824
2. Tax-exempt Organizations (Unrelated Business Income)						
Corporate	35	2	2	2	2	43
3. Private Foundations (Net Investment Income)						
Excise	125	17	5	7	10	164
F. Tax Litigation and Tax Court						
User Fees	*	*	*	*	*	*
G. Tax Administration Provisions						
Individual	-	-	-	-	-	-
Corporate	-	-	-	-	-	-
I. Waiver of Criminal Penalties if Voluntary Disclosure						
Individual	*	*	*	*	*	*
Corporate	*	*	*	*	*	*
J. Modify Withholding Schedules						
Individual	239	-487	-22	-20	-19	11
K. Increase in Voluntary Compliance						
Individual	58	490	693	652	668	2561
Corporate	-23	-54	-65	-66	-68	-276
SUBTOTAL						
Individual	2210	1140	2353	2490	2636	10829
Corporate	105	271	355	471	608	1810
User Fees	0	0	0	0	0	0
Excise	126	25	14	17	20	202
Estate and Gift	0	5	7	7	7	26
Outlays	-35	-140	-144	-111	-114	-544
SUBTOTAL, COMPLIANCE	2406	1301	2585	2874	3157	12323

VI. CORPORATE AND GENERAL BUSINESS TAXATION

	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-91 1/
			($ Millions)			
A. Corporate Tax Rates 5/						
Revise corporate rates and graduated structure (top rate to 34%)						
Corporate	-6629	-19092	-27562	-31760	-35189	-120232
B. Dividends Received Deduction						
Reduce dividend received deduction for corporations to 80%						
Corporate	126	209	222	241	257	1055
C. Repeal $100 Dividend Exclusion for Individuals						
Individual	87	576	568	586	604	2421
D. Redemption of Stock Payments						
Repeal deductibility of "greenmail" payments						
Corporate	**	**	**	**	**	**
E. Special Limitations on Net Operating Loss Carryovers						
Corporate	9	29	39	38	29	144
F. Repeal "General Utilities" Rule						
Individual	-342	-1404	-1474	-1548	-1625	-6393
Corporate	228	1057	1336	1622	1887	6130
G. Allocation of Purchase Price in Certain Sales of Assets						
Individual	-6	-7	-7	-7	-7	-34
Corporate	71	68	85	101	114	439
H. Extraordinary Dividends Received						
Corporate	30	52	54	57	60	253
I. Repeal Various Rapid Amortization Elections						
Repeal 5 year amortization for trademark expenses						
Individual	0	3	8	15	23	49
Corporate	2	6	15	26	38	87
Amortization of railroad tunnels and bores						
Corporate	*	*	*	*	*	*
Five year write off of bus operating rights						
Corporate	-20	-	-	-	-	-20
J. Other Capital Related Costs						
Limit Marine CCF						
Corporate	3	4	5	6	6	24
K. Tax Regulated Investment Companies on Calendar Year Basis and Eliminate "Spillover" Dividends						
Individual	406	471	26	27	27	957
Excise	-	6	6	6	7	25

	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-91 1/
			($ Millions)			
L. Mortgage-Backed Securities—REMICs						
Corporate	-2	-6	-13	-23	-32	-76
SUBTOTAL						
Individual	145	-361	-879	-927	-978	-3000
Corporate	-6182	-17673	-25819	-29692	-32830	-112196
Excise	0	6	6	6	7	25
SUBTOTAL, CORP. AND GENERAL BUSINESS TAXATION	-6037	-18028	-26692	-30613	-33801	-115171
VII. ENERGY, AGRICULTURE, TIMBER, AND NATURAL RESOURCES						
Agriculture						
A. Agriculture - Limit Soil and Water Conservation Expenditures and Repeal Expenditures for Clearing Land						
Individual	29	25	25	25	25	129
Corporate	15	11	11	11	11	59
B. Restrict Prepayments of Farming Expenses Over 50% of Annual Expenses						
Individual	50	5	2	2	2	61
C. Extend Scope of Expensing of Costs of Replanting						
Individual	-1	-6	-10	-13	-13	-43
Corporate	-*	-*	-*	-*	-*	-*
D. Discharge of Indebtedness Treatment of Farmers						
Individual	-9	-10	-8	-7	-5	-39
E. Capitalization of Preproductive Expenditures						
Individual	56	160	147	141	146	650
Corporate	41	61	55	53	53	263
Energy and Natural Resources						
A. Domestic Production						
Percentage Depletion Offset for Coal & Iron Ore Royalties Due to Deletion of Capital Gains Rates						
Individual	-7	-17	-17	-18	-19	-78
Corporate	-1	-2	-2	-2	-3	-10
Oil and Gas (except foreign IDC's)						
Individual	19	52	59	68	77	275
Corporate	56	104	125	136	118	539
Hard Minerals E&D and Percentage Depletion						
Individual	0	0	0	0	0	0
Corporate	20	30	28	27	26	131

	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-91 1/
			($ Millions)			
B. Foreign Exploration and Development Costs and IDC's						
Corporate	4	6	5	5	1	21
C. Extend Energy Related Credits and Incentives at Reduced Rates						
Extend solar, geothermal, biomass, wind, and ocean credits						
Individual	-*	-*	-*	-*	-*	-*
Corporate	-380	-87	11	22	15	-419
D. Allow Residential Energy Credits to Expire						
Individual	-	-	-	-	-	-
F. Reduce Gas Exemption for Methanol Neat Alcohol to $.06						
Individual	-*	-*	-*	-*	-*	-*
Corporate	-*	-*	-*	-*	-*	-*
Excise	-*	-*	-*	-*	-*	-*
G. Deny Duty-Free Treatment to Ethyl Alcohol from CBI Unless CBI is Source						
Individual	-*	-*	-*	-*	-*	-*
Corporate	-*	-*	-*	-*	-*	-*
Excise	*	*	*	*	*	*
Customs	*	*	*	*	*	*
H. Gift and Estate Tax Deductions for Conservation Easements						
Individual	-*	-*	-*	-*	-*	-*
Estate and Gift	-*	-*	-*	-*	-*	-*
SUBTOTAL						
Individual	137	209	198	198	213	955
Corporate	-245	123	233	252	221	584
Excise	0	0	0	0	0	0
Estate and Gift	0	0	0	0	0	0
Customs	0	0	0	0	0	0
SUBTOTAL, ENERGY, AGRIC., TIMBER, & NAT. RES.	-108	332	431	450	434	1539
VIII. EMPLOYMENT AND EXCISE TAXES						
A. Employment Taxes						
Ministerial Reelection into FICA						
FICA	*	*	*	*	*	*
FUTA for Indian Tribes	-*	-*	-	-	-	-
B. Excise Taxes						
Medivac Helicopters						
Excise	-*	-*	-*	-*	-*	-*

	Fiscal Year 1987	1988	1989	1990	1991	Totals, 1987-91 1/
			($ Millions)			
SUBTOTAL						
Individual	0	0	0	0	0	0
Excise	0	0	0	0	0	0
FICA	0	0	0	0	0	0
FUTA	0	0	0	0	0	0
SUBTOTAL, EMPLOYMENT AND EXCISE TAXES	0	0	0	0	0	0
IX. FINANCIAL INSTITUTIONS						
A. Reserve for Bad Debts						
1. Commercial banks, Corporate	195	560	878	1163	588	3384
2. Thrift institutions, Corporate	60	90	100	110	130	490
B. Interest On Debt to Purchase Or Carry Tax-exempt Obligations						
Individual	-56	-299	-676	-1059	-1448	-3538
Corporate	85	384	776	1156	1535	3936
C. Allow NOL's of Thrifts to Eight Year Carryforward						
Corporate	0	-60	-100	-100	-80	-340
D. Reorganizations of Financially Troubled Thrifts						
Corporate	0	0	50	100	160	310
E. Losses on Deposits in Insolvent Financial Institutions						
Individual	-3	-1	-1	-1	-1	-7
SUBTOTAL						
Individual	-59	-300	-677	-1060	-1449	-3545
Corporate	340	974	1704	2429	2333	7780
SUBTOTAL, FINANCIAL INSTITUTIONS	281	674	1027	1369	884	4235
X. FOREIGN TAX PROVISIONS						
A. Foreign Tax Credits						
Separate Foreign Tax Limitations						
Corporate	279	445	430	457	488	2099
Credit for high withholding taxes on interest						
Corporate	111	174	158	258	409	1110
Treatment of losses						
Corporate	9	21	24	25	27	106
Deemed-paid credit						
Corporate	6	20	61	88	99	274
B. Source Rules						
Sales of inventory and property						
Corporate	*	*	*	*	*	*

	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-91 1/
	($ Millions)					
Transportation income						
Corporate	8	16	19	25	31	99
Dividends and interest of 80/20's						
Corporate	*	*	*	*	*	*
Allocation of interest expenses						
Corporate	143	381	602	820	1002	2948
Allocation of expenses other than interest and R&D						
Corporate	58	92	97	102	107	456
C. Foreign Corporations of U.S. Taxpayers						
Expand subpart F income						
Corporate	110	184	179	196	216	885
De minimis tax have income rule						
Corporate	40	67	68	77	81	333
Use of deficits in E&P						
Corporate	14	22	22	26	27	111
D. Special Tax Provisions						
Possesions tax credit						
Corporate	42	69	68	75	82	336
Transfers of intangibles						
Corporate	24	60	83	110	140	417
Foreign investment companies						
Corporate	10	17	16	19	21	83
E. Foreign Taxpayers						
Branch level tax						
Corporate	*	*	*	*	*	*
Insurance: capative insurance companies						
Corporate	25	64	88	115	146	438
Income of foreign governments						
Corporate	23	44	49	55	60	231
Dual residence companies						
Corporate	73	126	132	140	151	622
F. Foreign Currency Exchange Gains and Losses						
Corporate	*	*	*	*	*	*
G. Reduce Section 911 Exclusion to $70,000						
Individual	23	44	49	55	60	231
SUBTOTAL						
Individual	23	44	49	55	60	231
Corporate	975	1802	2096	2588	3087	10548
SUBTOTAL, FOREIGN TAX PROVISIONS	998	1846	2145	2643	3147	10779

XI. INSURANCE PRODUCTS AND COMPANIES

A. Life Insurance Products and Companies

	Fiscal Year 1987	1988	1989	1990	1991	Totals, 1987-91 1/
	($ Millions)					
Repeal $1,000.00 exclusion of interest income on death benefits						
Individual	*	*	*	*	*	*
Allow NOLs for one insolvent life insurance company to offset distributions from policyholder surplus accounts						
Corporate	-*	-*	-*	-*	-*	-*
Tax Blue Cross-Blue Shield and certain other tax-exempt insurance companies under special tax rules						
Corporate	88	162	193	187	176	806
Tax structured settlement company investment income (except for settlements arising out of physical injury or sickness)						
Corporate	*	*	*	*	*	*
Repeal 20% life insurance company deduction						
Corporate	393	699	751	807	864	3514
Exempt certain burial insurance contracts from the statutory definition of life insurance						
Individual	-*	-*	-*	-*	-*	-**
Disallow deductions for interest payments on certain corporate policyholder loans						
Corporate	*	*	*	*	*	*
Disallow deductions for certain insured losses						
Corporate	*	*	*	*	*	*
B. Property and Casualty Insurance Companies						
Include 20% of annual increase in unearned premium reserves as taxable income (10% for bond insurance)						
Corporate	230	318	255	234	245	1282
Include 20% of existing unearned premuim reserve as taxable income (10% for bond insurance income) over next 6 years						
Corporate	254	432	469	512	495	2162
Reduce deductions for losses incurred by a specified proportion of tax-exempt interest & dividends received						
Corporate	19	74	156	258	358	865
Pretax discounting of loss reserves						
Corporate	374	667	757	714	566	3078
Repeal protection against loss account						
Corporate	58	76	68	44	24	270
Adopt single, small company provision						
Corporate	-14	-33	-27	-25	-24	-123
SUBTOTAL						
Individual	0	0	0	0	0	0
Corporate	1402	2395	2622	2731	2704	11854

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	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-91 1/
			($ Millions)			
SUBTOTAL, INSURANCE PRODUCTS AND COMPANIES	1402	2395	2622	2731	2704	11854
XII. INTEREST EXPENSE						
A. Nonbusiness Interest Limits						
Disallow consumer interest						
Individual	1095	2785	4056	5161	6056	19153
Limit investment interest						
Individual	145	351	495	638	768	2397
B. Disallow deduction for interest to fund IRA's						
Individual	*	*	*	*	*	*
SUBTOTAL						
Individual	1240	3136	4551	5799	6824	21550
SUBTOTAL, INTEREST EXPENSES	1240	3136	4551	5799	6824	21550
XIII. MINIMUM TAX						
A. Individual Minimum Tax (21%)						
Individual	1377	3656	948	-487	-1016	4478
B. Corporate Minimum Tax (20%) 4/						
Corporate	2717	4649	4760	4225	3532	19883
SUBTOTAL						
Individual	1377	3656	948	-487	-1016	4478
Corporate	2717	4649	4760	4225	3532	19883
SUBTOTAL, MINIMUM TAX	4094	8305	5708	3738	2516	24361
XIV. PENSIONS AND EMPLOYEE BENEFITS						
A. Pensions						
Limit IRA deduction for individuals not covered by retirement plans						
Individual	211	4758	4576	4609	4797	18951
Limit deferrals of employee cash or deferred arrangements, and tax-sheltered annuities to $7000. Additional $2500 deferral if invest in employer securities						
Individual	276	393	491	614	768	2542
Apply nondiscrimination tests of CODA's to all employer matching contributions						
Individual	**	**	**	**	**	**
Permit tax-exempt employers to maintain CODA's						
Individual	-**	-**	-**	-**	-**	-**
Modify coverage tests and vesting requirements of qualified plans						
Individual	**	**	**	**	**	**
10% additional income tax on early withdrawls						

	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-91 1/
			($ Millions)			
Individual	499	263	231	259	290	1542
Replace 10 year averaging with 5 year treatment						
Individual	95	277	211	284	344	1211
Define normal retirement age as social security age and adjust early retirement assumption						
Individual	600	900	1000	1200	1343	5043
Delay indexing of dollar limits to defined contribution plans						
Individual	0	1	2	4	5	12
10% excise on qualified plan reversions						
Excise	250	125	20	20	20	435
Phase out 3 year recovery rule						
Individual	1899	2100	1977	2049	2050	10075
Special rules for Simplified Employee Plans						
Individual	-15	-35	-40	-45	-50	-185
B. Employee Benefits						
Exclude educational assistance with cap						
Individual	-126	-38	-	-	-	-164
FICA	-69	-20	-	-	-	-89
Exclude group legal benefits						
Individual	-109	-38	-	-	-	-147
FICA	-42	-10	-	-	-	-52
Exclude campus lodging						
Individual	-*	-*	-*	-*	-*	-*
Allow self-employed to deduct 25% of health insurance premiums						
Individual	-126	-244	-307	-114	-	-791
Modify non-discrimination tests for health plans, group-term life insurance, and establish uniform definition of highly compensated employees						
Individual	-	75	132	144	156	507
Modify tangible prizes and awards treatment						
Individual	-17	-48	-51	-53	-56	-225
Modify accrued vacation pay						
Individual	5	8	2	2	2	19
Corporate	80	59	16	17	14	187
C. Employee Stock Ownership Plans (ESOP's)						
Repeal present law effective January 1, 1987						
Corporate	1220	1055	408	215	80	2978
Non-credit ESOP changes						
Corporate	-140	-188	-248	-293	-338	-1207
Estate and Gift	-666	-646	-1239	-1890	-2581	-7022
SUBTOTAL						
Individual	3192	8372	8224	8953	9649	38390
Corporate	1160	926	176	-61	-244	1958
Excise	250	125	20	20	20	435

	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-91 1/
			($ Millions)			
FICA	-111	-30	0	0	0	-141
Estate and Gift	-666	-646	-1239	-1890	-2581	-7022
SUBTOTAL, PENSIONS AND EMPLOYEE BENEFITS	3825	8747	7181	7022	6844	33620
XV. RESEARCH AND DEVELOPMENT PROVISIONS						
A. Extend and Modify R&D Credit Through 1988 at 20% Rate (Increase incentives for university research)						
Individual	-17	-15	-12	-6	-3	-53
Corporate	-1383	-1072	-739	-399	-245	-3838
B. Adopt Rule for Allocating R&D Expenditures Between U.S. and Foreign Income						
Corporate	-257	-138	0	0	0	-395
C. Exception for Personal Holding Company Rules in Developing Computer Software						
Corporate	-40	-10	-9	-7	-6	-72
D. Augmented charitable deduction for the donation of scientific equipment						
Corporate	*	*	*	*	*	*
SUBTOTAL						
Individual	-17	-15	-12	-6	-3	-53
Corporate	-1680	-1220	-748	-406	-251	-4305
SUBTOTAL, RESEARCH AND DEVELOPMENT PROVISIONS	-1697	-1235	-760	-412	-254	-4358
XVI TAX SHELTERS AND REAL ESTATE						
Tax Shelters						
A. Limit Nonparticipatory Losses and Credits (Passive Losses)						
Individual	841	3436	5856	8274	10352	28809
Corporate	-40	-269	-707	-1134	-1636	-3786
Real Estate						
A. At-risk Rules Extended to Real Estate (Except third party non-recourse debt)						
Individual	*	*	*	*	*	*
B. 20% Credit for Historic Structures and 10% Credit for Other Rehabilitation Expenditures						
Individual	61	222	343	410	472	1508
Corporate	42	122	174	205	232	775
C. New Credit for Low Income Rental Housing						

	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-91 1/
			($ Millions)			
Individual	-80	-297	-535	-707	-798	-2417
Corporate	-7	-26	-47	-62	-71	-213
D. Modify Taxation of Real Estate Investment Trusts						
Corporate	20	17	-8	-11	-14	4
SUBTOTAL						
Individual	822	3411	5664	7977	10026	27900
Corporate	15	-156	-588	-1002	-1489	-3220
SUBTOTAL, TAX SHELTERS AND REAL ESTATE	837	3255	5076	6975	8537	24680
XVII. TAX-EXEMPT BONDS						
A. Restrict arbitrage and limit nongovernmental use						
Individual	173	596	922	1181	1427	4299
Corporate	299	521	481	350	193	1844
B. Modify Refunding Rules for Tax-Exempt Bonds						
Individual	14	70	167	270	342	863
Corporate	*	*	*	*	*	*
C. Extend Information Reporting Requirements to all tax-exempt bonds						
Individual	*	*	*	*	*	*
Corporate	*	*	*	*	*	*
SUBTOTAL						
Individual	187	666	1089	1451	1769	5162
Corporate	299	521	481	350	193	1844
SUBTOTAL, TAX-EXEMPT BONDS	486	1187	1570	1801	1962	7006
XVIII. TAXATION OF TRUSTS, ESTATES, AND MINOR CHILDREN						
A. Unearned Income of Children Under Age 14						
Tax unearned income of children under age 14 at parent's top marginal rate						
Individual	92	254	208	224	234	1012
B. Compress Present Law Rate Schedule for Income Estates						
Individual	5	21	32	34	35	127
Trusts						
Individual	30	124	194	203	214	765
C. Modified Taxation of Grantor Trusts						
Individual	**	**	**	**	**	100
D. Generation-skipping Transfer Tax						
Estate and Gift	-*	-*	-*	-*	-*	-*

	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-91 1/
	($ Millions)					
E. Shorten Holding Period for Special Recapture Tax on Heirs						
Individual	*	*	*	*	*	*
F. Extension of Time to Supply Information on Certain Estate Tax Returns						
Individual	-*	-*	-*	-*	-*	-*
G. Decrease Period of Tax Deferral for Trusts						
Individual	1150	128	133	135	137	1683
H. Payment of Income Taxes of Estates						
Individual	361	257	29	31	32	710
SUBTOTAL						
Individual	1638	784	596	627	652	4297
Estate and Gift	0	0	0	0	0	
SUBTOTAL, TAXATION OF TRUSTS AND ESTATES	1638	784	596	627	652	4297
XIX. MISCELLANEOUS PROVISIONS						
A. Extend/Modify Targeted Jobs Credits for 3 Years (40% rate for first year employment and no credit for second year employment)						
Individual	-22	-36	-39	-23	-14	-134
Corporate	-145	-240	-198	-111	-58	-752
B. Extend Expensing Costs for Removing Barriers to Handicapped						
Individual	-2	-1	-1	-1	-2	-7
Corporate	-21	-12	-14	-16	-18	-81
C. Tax Relief for Vietnam MIA Spouses						
Individual	-*	-*	-*	-*	-*	-*
D. Exempt and Nonprofit Organizations						
Rentals of membership lists						
Corporate	-4	-8	-7	-8	-9	-36
Tax exemption for certain title holding companies						
Individual	-2	-7	-11	-19	-29	-68
Corporate	-3	-13	-22	-36	-57	-131
Exempt trade show income						
Corporate	-4	-8	-12	-16	-22	-62
Exception to membership organization deduction rules						
Corporate	0	-*	-*	-*	-*	-*
Excise	0	-*	-*	-*	-*	-*
Tax-exempt status for technology transfer organization						
Corporation	-*	-*	-*	-*	-*	-*

	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-91 1/
			($ Millions)			
Distribution of Low-Cost Articles by Charities						
Corporation	-	-*	-*	-*	-*	-*
E. Diesel Tax at Wholesale Level						
Excise	5	*	*	*	*	5
F. Allocation of Co-op Housing Interest and Taxes						
Corporate	-*	-*	-*	-*	-*	-*
G. Change in Gasoline Excise Tax						
Individual	-	-12	-19	-19	-19	-69
Corporate	-	-2	-3	-3	-3	-11
Excise	-	300	200	200	200	900
H. Foster Care Payment						
Individual	-5	-8	-9	-11	-12	-45
I. Reindeer Related Income						
Individual	-*	-*	-*	-*	-*	-*
J. Treatment of Certain Technical Personnel						
Individual	-*	-*	-*	-*	-*	-*
FICA	*	*	*	*	*	*
SECA	-*	-*	-*	-*	-*	-*
FUTA	*	*	*	*	*	*
SUBTOTAL						
Individual	-31	-64	-79	-73	-76	-323
Corporate	-177	-283	-256	-190	-167	-1073
Excise	5	300	200	200	200	905
FICA	-*	-*	-*	-*	-*	-*
SECA	-*	-*	-*	-*	-*	-*
FUTA	-*	-*	-*	-*	-*	-*
SUBTOTAL, MISCELLANEOUS PROVISIONS	-203	-47	-135	-63	-43	-491
XX. TECHNICAL CORRECTIONS TO RECENTLY ENACTED LEGISLATION						
SUBTOTAL						
Individual	0	0	0	0	0	0
Corporate	-175	0	0	0	0	-175
Customs	0	0	0	0	0	0
Excise	0	0	0	0	0	0
Estate and Gift	0	0	0	0	0	0
FICA	0	0	0	0	0	0
FUTA	0	0	0	0	0	0
SECA	0	0	0	0	0	0
SUBTOTAL, TECHNICAL CORRECTIONS	-175	0	0	0	0	-175

	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-91 1/
	($ Millions)					
SUMMARY, TAX REFORM ACT OF 1986, BY SOURCE OF ESTIMATED REVENUE:						
TOTALS:						
Individual	-9294	-24196	-34216	-32833	-29768	-136306
Corporate	28252	25155	23395	25320	27717	129838
Excise	381	456	240	243	247	1567
Customs	0	0	0	0	0	0
Estate and Gift	-666	-641	-1232	-1883	-2574	-6996
FICA and SECA	-48	82	133	149	180	496
FUTA	0	0	0	0	0	0
Outlays	-87	-1675	-2793	-2830	-2878	-10263
TOTAL UNIFIED BUDGET EFFECT	18538	-819	-14473	-11834	-7076	-15664
Outlays	-87	-1675	-2793	-2830	-2878	-10263
TOTAL UNIFIED BUDGET RECEIPTS EFFECT	18625	856	-11680	-9004	-4198	-5401

Department of the Treasury
Office of Tax Analysis

13-Jan-87

	Fiscal Year					Totals,
	1987	1988	1989	1990	1991	1987-91 1/
			($ Millions)			

Notes:

*   = less than $5 million
** = less than $50 million

".0" Indicates a rounded number greater than zero but
less than $50 million
"0.0" indicates orginal entry is zero

Note A: The estimates are based on the Fiscal Year (FY) 1988 budget forecast. In general, the effects of each individual provision are estimated assuming enactment of all other provisions. Corporate provisions were estimated in the following sequence: 1) rate changes; 2) changes in credits; 3) changes in capital recovery provisions; 4) base broadeners; and 5) minimum tax provisions.

Note B: The individual estimates assume that the relationship between collections and tax liability is unchanged from current law. Fiscal year revenue effects may be significantly altered depending on the prescribed changes in the withholding tables and rules governing payment of estimated taxes.

1/ Six year totals may not add due to rounding.
2/ Outlays shown as negatives.
3/ A direct expenditure program under Social Security is expected to offset the revenue increases.
4/ Does not include the Blue Cross/Blue Shield effect, which
is included in a separate provision.
5/ Does not include any effect of Tax Reform on corporate estimated payments made during FY 1986.

Chairman Chiles. Senator Sanford.

Senator Sanford. Well, thank you very much. One great advantage of coming in late is that by the time it comes to your turn, all the questions have been asked and everybody is worn out, anyhow.

Chairman Chiles. Do not say that. I have not asked my questions yet. [Laughter.]

Senator Sanford. Well, I thought you were the one that was worn out.

LEADERSHIP LACKING IN BUDGET

I think that I would like to talk just a little bit about the leadership that I believe I observe is lacking in the way this budget comes over. It may be based on mistakes of the past, and I would certainly join my colleagues in praising your conduct in this office and your initiatives of the last couple of years. I would further comment that you look extremely good compared to your predecessor.

The point is, I think that we talk now about getting away from rhetoric, but we are not really getting away from rhetoric. To talk about productivity, to talk about competitiveness is one thing, and of course we want to do it. But then as I listen to you and as I look at the budget, it seems to me that the real initiatives that ought to be coming from the White House are not forthcoming.

I thought, I might say, for the last 6 years that the President was under some obligation to send over a balanced budget. But that is behind us now, and the circumstances in which we now find ourselves are these that have to be contended with.

As we talk about productivity and competitiveness, it seems to me that we have got the same kind of lack of concrete leadership in fundamentals. And let me just mention three. I do not really see an understanding of what our lack of a sound trade policy has done to this Nation. And when we talk about having lost only a million manufacturing jobs since the beginning of this administration, that does not say very much.

We ought to, in an expanding economy, have seen a great many new manufacturing and high-paying jobs created, and we simply have not. Now, there is something wrong with that. There is something wrong with our approach to manpower development. I think that we do need a trade policy, and I think we have to have a trade policy that gets back to the reciprocal concept that we had many years ago.

I think other nations do have to pull their load, and I think we do have to put an additional burden on Germany and Japan to help us open other markets to the rest of the world. And I do not see that coming forward as it should come forward, it seems to me, from the administration.

SECURITIES PROBLEM

I do not see, just on a side point that I had not thought of, but the securities problem is not Mr. Boesky; it is not insider trading. It is the massive transfer of equity to debt. That puts us in a kind of jeopardy when it comes to productivity that a great many people have not given enough thought to simply because if we do not have the equity we cannot have the expansion and the modernization. And every time we see one of these leveraged buy-outs or one of these junk bonds deals, we lose equity to debt which further burdens our chance of being competitive and productive.

So there, again, I think we have had an attitude that has not gotten at the basics. Then we look at the deficits in the debt. There is not any question that it has been very beneficial to have low interest rates, and there is not any question that it has been extremely beneficial to have stopped inflation.

Well, that is a result of a lot of things, including the Federal Reserve, but we have paid a tremendous price. We have created the greatest national debt in the history of the world in just a half a dozen years. What is that going to do for the future, and how are we going to handle that?

EDUCATION

Finally, let me just comment on one other thing that I think we see talked about but very little action taken on and, I would suggest, very little understanding of; and that is education. I was appalled to see a statement that I think can be interpreted in no other way but that education is for the benefit of the student. Well, of course, it is for the benefit of the student. But the State, the public, has always made education available, and for us now to cut back education, to cut back opportunities because it is for the benefit of individuals, misses the point that this is the fundamental basis on which we build a stronger Nation.

So when we cut back education, we are cutting off any chance of getting more productive and more competitive. And I simply do not think we can live with that kind of a policy. I know very well young people who are going to college now that would not have dreamed it would be possible to go to college because of the Federal program of student aid. And even more important, I know there are ninth-graders who are thinking, well, yes, I can aspire to go to college and I can someday do better than I am now because those funds are available.

So I think the administration is missing some very fundamental points. And I am not saying that so much in condemnation as in a plea, I think, to be more creative and to look at these fundamentals. I know the President is preoccupied with taxes. He said during my campaign three times that I would come and tax and spend.

The point is, we have got to get to the fundamentals if we are going to look at this, and we cannot be preoccupied just with some kind of dogmatic approach to problems, an approach, perhaps, coming out of the past. I think we need to be creative in education, in trade, and in our handling of the debt.

That is more a statement, if you will excuse it, instead of a question. I thank you for being here, Mr. Secretary.

Chairman CHILES. Mr. Secretary, I want you to know I think I have learned something from this hearing. I thank you very much for your appearance.

DON'T CALL IT SUMMIT

Before I ask you any questions, I want to tell you that what I have learned is that we are not to use that word "summit" any more. So I am going to erase that from my vocabulary; I am going to wash my mouth out with soap if I am tempted to say that, and I am just not going to say that word any more.

But I am going to continue to say my prayers, and I think he is going to know what I am talking about. Because I think the country just so desperately needs it, I hope to get a meeting in where the President can serve as the leader and the catalyst. You have had an opportunity to hear from both sides of the aisle today. I think you have noted we are not here for confrontation.

You have heard people from the most liberal side of the spectrum to those that are on the conservative side saying we recognize that the country has needs here. A lot of people are ready to put aside their personal agenda to see that we try to tend to those needs.

I hope you will carry that back with you to the President. We think that is terribly important.

I want to compliment again you on your statement and your response to questions. You are always tremendously prepared.

NEW TRADE BILL

I want to touch on a couple of areas. One is international trade. You know that the Congress is going to develop a trade bill. I hope it will be a market-opening bill rather than a bill that seeks to protect, or close things.

I have introduced a bill, as others have. Mine would set some bottom line goals. It would tell the Japanese, for example, they must at least open their markets to us on the order of $10 billion over a period of 3 years. We would give them a goal like that and say if you do not open your markets to us in that period of time, then we will exercise some of the restraints that you are using against us.

I have determined that you cannot deal with the Japanese on a product-by-product basis. I tried to do that for a number of years. It does not work. They say they will lose their political structure or the country will almost go Communist if they allow oranges or something else to come in. They will tell you about their customs. So I think it has got to be something on that bottom line.

What is your feeling?

Secretary **Baker**. Mr. Chairman, I would say amen to your statement that we ought to concentrate on measures to open markets. I think that you will find that the administration will be proposing legislation that seeks to do that, that seeks to beef up our trade laws. And commenting just briefly on what Senator Sanford said and what I said to Senator Quayle, obviously everything that we have in mind is not contained in a budget submission.

WE MIGHT LOSE TRADE WAR

I would note that we have significant increases in the budget for R&D and for other such programs, and these will indicate whether or not we are sensitive to the problems of competitiveness. I think mandatory retaliation provisions should be examined very, very carefully, because retaliation is not cost-free. Sometimes it may result in the kind of action that you are seeking to force, and sometimes it might result in an all-out trade war, which we might well not win.

So I think that kind of a provision should be looked at and looked at extremely closely. I am not in a position today to say that the administration would embrace that. We have had extensive discussions in our Economic Policy Council about some of the provisions that we would like to see in a new bill to enhance America's competitiveness. It is up to the President to talk to the specifics of that, but I certainly do agree with you that our whole thrust and focus should be to open markets abroad, not to close markets here. For one thing, all of us who are interested in not only preserving free trade but fair trade fear, once this process begins to move up here on the Hill, that we are going to see a tendency on the floor of both Houses to add provisions that get into market closing measures. And then you are going to have product-specific suggestions coming from various sectors, because that is the what I think the politics of the situation demand.

So I am sorry that I am not in a position today to say yea or nay to the type of provision you suggest. It is a mandatory retaliation provision. I think we have to look very carefully at those. We do need to strengthen the laws that will help us to open markets abroad.

FMS LOAN REFINANCING APPROVED

Chairman **Chiles**. Mr. Secretary, I understand the President has already approved changing the financing arrangements on existing foreign military sale loans to allow foreign countries to either repay their loans without penalty or reduce the interest rate to par and defer the difference for 20 to 30 years.

The administration efforts show that these proposals will cost the American taxpayer almost $1.2 billion in lost receipts in 1988 alone.

I know you can say that allowing prepayment, in effect selling the loan, will more than cover the first cost of those changed. But in reality, this proposal is going to cost tens of billions of dollars over the coming years.

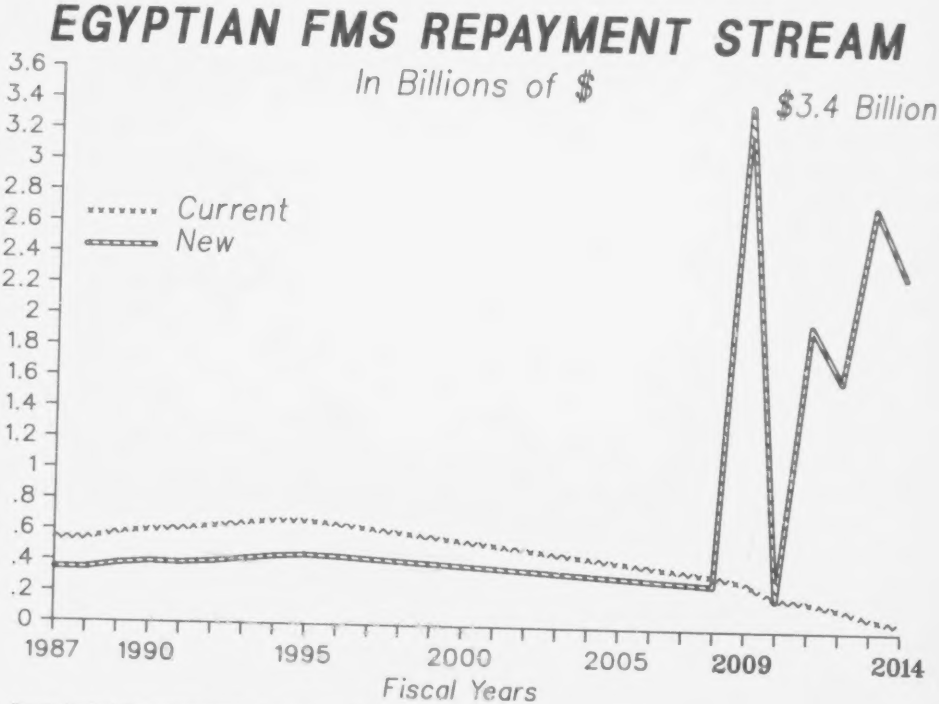
Can you tell the committee what the true cost of the program is going to be? Just last year, Treasury fought hard to prevent the large repayments to our rural electric cooperatives. We are concerned about the policy now changing to foreign sales. Is this a signal that Treasury is prepared to make this policy change to others burdened by debts such as our farmer and our students?

Secretary **Baker**. Mr. Chairman, with respect to the interest capitalization option that the President decided to make available to foreign military sales debtors, I do not know why it would not be appropriate to consider such an option. It does not reduce the obligation of the debtor. It does not reduce the obligation of the particular country that we are dealing with on foreign military sales. It does not reduce the obligation. Suppose you extended it to the REA, it would not reduce the obligation, the total dollar obligation, of the REA. So, in that regard, perhaps we should give some consideration to it.

FMS SALES HELP REDUCE DEFENSE COSTS

I think you have to look at these FMS sales a little bit differently, if I might suggest, than you do debt that is generated domestically. In the first place, these countries are helping us reduce our defense costs by buying military equipment from the United States and operating that military equipment overseas. What we are really doing is charging them high rates of interest for the privilege of defraying our direct defense expenditures. We are charging them interest at 14, 15, 16 percent.

The President made a specific national security determination with respect to these matters that, of course, would not pertain to domestic borrowers. And if the Congress feels that we should do this with respect to domestic borrowers, it seems to us that the situation is sufficiently different that the Congress should go ahead and appropriate the money and let us do it. Pass a law that says we are going to do it——



Senate Budget Committee Staff, January 6, 1987

Chairman CHILES. But we are not appropriating the money to do this, are we?

Secretary BAKER. No, we are not, because as I have just said, the President has made a national security determination——

SOUTH KOREA

Chairman **Chiles**. Is it a national security determination to forgive South Korea?

Secretary **Baker**. We are not—no.

Chairman **Chiles**. Allow them to buy back——

Secretary **Baker**. We are not forgiving them, Mr. Chairman. The prepayment option that exists with respect to some of this FMS debt does not exist with respect to much of the domestic debt that is held in the Federal Financing Bank. It does with respect to some, but for a lot of it it does not.

Chairman **Chiles**. Why should we allow South Korea—which at the present we are enjoying a very negative balance of trade with, a country with a very strong economy—to prepay loans when we know that over a period of time they are going to pay that loan back at a higher interest rate which was the rate we borrowed the money for them to start with to let them have the loan?

Secretary **Baker**. In the first place, the loan agreements provide for prepayment. In the second place——

Chairman **Chiles**. Wait a minute. They provide for prepayment.

Secretary **Baker**. That is correct.

Chairman **Chiles**. At our discretion?

Secretary **Baker**. At our discretion; that is correct.

Chairman **Chiles**. Well, then, I just asked you. Why are we making this decision?

Secretary **Baker**. A lot of the domestic debt that you are talking about does not provide for prepayment at our discretion.

Why are we doing this? We are doing it because the President specifically concluded that it was in the national security interest of the United States to do it.

Chairman **Chiles**. Why? For South Korea, tell me why.

Secretary **Baker**. Because these people are out there spending their money and——

Chairman **Chiles**. These people that are beating us to death at the trade table, that enjoy a tremendous favorable balance of trade, who have a very strong economy, why do we have to give them a break now? And it is our discretion? That seems to me to be dumb.

Secretary **Baker**. Well, it does not seem to the President to be dumb, Mr. Chairman, and he concluded that this was something that should be done. And if you are going to offer it to Egypt and Israel, it is pretty darn tough to say no, you are not going to give it to South Korea when they are right out there on the front lines, and we have got a lot of Americans out there helping them to defend what we both believe in. That is the reason he made the determination.

Chairman **Chiles**. I just do not see how in the world that can be in our best interest to do it.

Secretary **Baker**. We are charging these countries very, very high rates for the privilege of helping us defray our defense expenditures. That is basically what it boils down to in the President's view. That is the basis of the national security determination.

Chairman **Chiles**. It seems like to me South Korea has some interest independent themselves——

Secretary **Baker**. They do.

Chairman **Chiles**. And we started off borrowing the money to allow them to have this to start with, and we still owe that money. We have not paid it back yet because we still have this big deficit. Now, we are going to give them a concessionary rate or allow them to buy down on this, at the same time that they enjoy a very strong, very healthy economy, a very favorable balance with us. I cannot understand why we are trying to do that. It certainly has to cost us. It certainly is going to cost us money over a period of years.

Secretary **Baker**. One of the options will cost us over a period of years, probably the one that would be available to South Korea. But the interest capitalization option will not cost us over the long term.

EGYPT

Chairman **Chiles**. Well, I just think it has to. Look at Egypt now. When the year 2009 comes along, they are going to have to pay off $3.4 billion. They are going to have a $3.4 billion balloon.

Secretary **Baker**. That is right.

Chairman **Chiles**. Do you think they are going to be able to pay that balloon?

Secretary **Baker**. I do not know whether they are going to be able to pay it or not, but it is going to be legally obligated to the United States and we are not forgiving it. The point is——

Chairman **Chiles**. And, of course, you are not going to have to worry about it, and I probably will not either. I know I will not have to worry about it at that time.

Senator **Symms**. You may be President by then.

Chairman **Chiles**. But it seems to me that we are putting a heck of a burden on them to assume they would be able to do that, and it just provides a concession right now.

I tell you, it looks like to me that it is a way of going around providing additional aid to these countries now, something that the Congress did not approve. I think the better way would be to come through the Congress and get the approval before these steps are made.

CUTS IN DRUG ENFORCEMENT

Mr. Secretary, I see your plan includes a $38.9 million rescission in the Customs Service and a $51 million cut in the air interdiction program for 1988. That proposal amounts to another 50-percent cut in a congressionally-mandated drug bill program.

I wonder if you could enlighten me why you would propose a 50-percent cut in air interdiction, an effort that has been extremely useful in Florida, and all across the Southeast and the Southwest. Would you comment on why the President would propose cutting coastal surveillance? Is that a way to win the war on drugs?

Secretary **Baker**. Well, Mr. Chairman, the air interdiction item is not a rescission. It is simply a deferral while the National Drug Enforcement Policy Board tries to sort out some of the differences between the various agencies about who ought to have the air interdiction responsibility and what kind of aircraft should be used.

It is not a rescission. It is simply a deferral for that reason. There is a difference of opinion among some of the agencies, and quite a difference of opinion among some of the committees up here in the Congress. We are not rescinding that. We are simply deferring it until the National Drug Enforcement Policy Board can make a determination.

Chairman CHILES. My understanding is there is about $37 million of 1987 money you are talking about not spending.

Secretary BAKER. Are you talking about air interdiction now?

Chairman CHILES. That is right.

Secretary BAKER. My recollection on that is it is a $52 million deferral, and that is all it is regarding air interdiction.

Chairman CHILES. There is a $51 million deferral, but last year we provided $171 million. This year you are talking about providing $86 million. That looks like 50 percent of what was provided last year.

Secretary BAKER. Well, it says that we are proposing to defer $51.2 million of the $171 million of fiscal 1987 funds appropriated for the Customs air effort, and that is the $51 million. I do not know what else—on E-2C aircraft, we are deferring $3 million; on C3I centers, 22,235,000; on P3 radar retrofitting, nearly 20 million; on spare equipment, $700,000; on C-12 aircraft, 6½ million, and on operations and equipment, there is a net add-on there of $700,000.

Chairman CHILES. The way our figures look, we had about $171 million in 1987.

Secretary BAKER. Yes.

Chairman CHILES. And we are talking about deferring $51 million of that. That would leave you about $120 million.

Secretary BAKER. Right.

Chairman CHILES. You are asking for $86 million to spend, so there is a difference of $34 million if you have got $120 million, so you still do not get up to approximately half of what you had before. We will go over those figures with you and see if we cannot straighten it out.

Secretary BAKER. We will supply what we have down there, Mr. Chairman.

Chairman CHILES. All right.

[The following was subsequently supplied for the record by the Treasury Department:]

THE SECRETARY OF THE TREASURY
WASHINGTON

January 20, 1987

Lawton

Dear Senator Chiles:

Knowing your interest in the Customs Service and drug policy, I am writing to notify you of a budgetary development that has occurred since my testimony before the Senate Budget Committee on January 8, 1987. At that hearing, I noted that the Administration will propose a deferral of $51,230,000 in the FY 1987 appropriation for Customs Aircraft Operations & Maintenance. OMB notified us the day after I testified that it is now considering a different approach.

The proposal contains a change in approach towards the $19,131,000 for P3 radar modification, which I had said would be deferred. OMB will now agree to funding of this project in FY 1987, if it is approved by the National Drug Enforcement Policy Board. This aspect of the proposal would be of benefit to Customs and to the drug interdiction effort in general, because it would allow for acceleration of the project.

The new OMB approach would seek Congressional approval of supplemental appropriation language to delay spending of $32,099,000 until FY 1988. These funds are currently available in the Continuing Resolution without fiscal year limitation. With enactment of this new language, they would not be available until FY 1988. The money would remain available to Customs unless Congress approves the delay.

I understand that OMB Director Miller has written Senator DeConcini directly regarding this proposal. I wanted, however, to notify you myself since I testified on the matter.

As always, I welcome your comments on the issue.

Sincerely,

Jim

James A. Baker, III

The Honorable Lawton Chiles
Chairman
Committee on the Budget
United States Senate
Washington, DC 20510

Chairman CHILES. Then Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman.

U.S. /FOREIGN PRODUCTIVITY RATES

Mr. Secretary, I intend to go back into the foreign loans by the international development banks and make some further points on that, but listening to this discussion here, I think that we should continue here because you said something that was rather interesting on this productivity growth rate.

I just want to read a brief paragraph to you and then ask you to comment on that chart, because in my view that chart is quite misleading of what has really happened in U.S. productivity since 1980.[1]

I just want to quote from the article by Lindley Clark on December 4 in the Wall Street Journal, which said about manufacturing output, and I quote, "has increased nearly 30 percent since late 1982"; that is, manufacturing output in the United States.

That 30 percent gain in manufacturing output has almost escaped the media's attention, even though no other major country, including Japan, did that well. Yet, even in Clark's article, the main point is to complain that, quote, "the number of manufacturing jobs has increased less than 6 percent, less than 1 million."

So the so-called crisis in U.S. manufacturing turns out to be huge productivity gains. Specifically, manufacturing productivity rose by 4.1 percent a year in 1981 through 1985, recession included, compared with a 0.9 percent annual increase from 1976 to 1980.

Clark shows a zero productivity increase in services, but that is because the statisticians assume a zero increase. They do not have the slightest idea of how to measure the quality of medical or financial services, much less Government services, and services make up most of our GNP.

So, is that not somewhat misleading, the chart that is up on the board there, about the U.S. producutivity being down at the bottom? Have we not actually outstripped in manufacturing productivity our major competitors?

Chairman CHILES. Manufacturing, as I understand it, is about 20 percent of our economy. My understanding is 70 percent of our total economy is exposed to foreign competition.

Senator SYMMS. But it is not the total for Japan, Italy, France, and Germany. It is mostly their manufacturing productivity.

Chairman CHILES. It is the total of all of those, yes; a total for all of them. We are using apples and apples.

Senator SYMMS. Go ahead, Mr. Secretary.

Secretary BAKER. All I was going to volunteer was that I think maybe there is no difference between what you are saying and what the Chairman is saying and what I said earlier, which is that productivity growth in the manufacturing sector has not been all that bad.

Chairman CHILES. In the manufacturing sector, I think you are right.

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[1] See chart on p. 91.

Secretary **Baker**. That is correct. It was 3.1 percent from 1979 through 1985, and that compares favorably, quite frankly, with some of our trading partners. It is one-tenth of one percent worse than Germany. Our manufacturing prodcutivity growth was also 3.1 percent between 1979 and 1986, incidently.

Our productivity growth is manufacturing was much better than Canada's and it was only slightly less than those of France and the United Kingdom, though considerably less than Japan's during the 1979–85 period.

Senator **Symms**. If we are better than Germany, why are we on the short end of that chart?

Secretary **Baker**. Because that chart covers the overall economy, not just manufacturing.

Senator **Symms**. Well, that is what I am saying. That chart is not accurate, then.

Secretary **Baker**. That chart covers the entire economy.

Chairman **Chiles**. That is our entire economy. You are not concerned about our entire economy?

Secretary **Baker**. But the point I think Senator Symms is making, Mr. Chairman, if I might suggest it——

Senator **Symms**. Yes, of course, Mr. Chairman.

Secretary **Baker**. As the article suggests, it is hard to measure productivity in the service sector.

Senator **Symms**. Right. We arbitrarily assume it is zero.

Secretary **Baker**. That is not something that we can really do with a great deal of certainty.

MONEY DEVALUATION INCREASES INFLATION

Senator **Symms**. OK. Now, the next question that does concern me—and this is a different subject, Mr. Secretary—in my perusal through history, I have never been able to see where a country debases its currency or tries to devalue its currency, so to speak, where in the end it does not get into some kind of a problem.

Now, we have gone through these last 2 or 3 years saying the dollar is overvalued, and now it is coming down and we expect, as you have said in your testimony, better trade relationships with the lower dollar ratio in the future.

But at what point does this start triggering domestic inflation, and do you have any concerns or fears about that in the future?

Secretary **Baker**. Well, I think that is a good question, Senator Symms, and, generally speaking, inflation tends to increase where you have a declining currency. But we have been extremely fortunate because during the period of time of the decline of the United States dollar, inflation has been historically low, in part because of the oil price decline. These two events have fortuitously taken place at the same time. I do not see any risk, as I indicated in my statement, of a resurgence of inflation. Is it going to be a little bit more than it was last year? Yes, because the oil price decline, it would appear, is basically behind us. But I do not think we are going to see any substantial acceleration of inflation in this country as a consequence of the fact that the dollar has come down in a very reasonable, orderly and moderate way against these other main nondollar currencies, which, by the way, I would not equate with debasing the currency.

Senator SYMMS. Well, that might have been too strong of a statement. I would have to say in my part of the country, I am not sure that a little bit of inflation would not be welcome by some of the commodity production sectors.

But for the long run, I think that it does hurt—you know, this is how we ended up with the high interest rates after the big inflation of the 1970's that created so much havoc in the commodity-producing sector of the economy.

Thank you very much, Mr. Chairman.

Chairman CHILES. Thank you.

Senator SYMMS. I think it has been an excellent hearing. I share your viewpoint on this hearing this morning.

Chairman CHILES. Thank you.

Senator Lautenberg.

LAZY FACTOR CAUSE OF MANY CORPORATE TAKEOVERS

Senator LAUTENBERG. Yes; just briefly, Mr. Secretary, I would like to clear up one point that was made on the record here. I have some problem, having coming from the corporate sector, when I hear we hear this criticism of buy-outs, takeovers, and so forth.

When corporate management does not employ its resources effectively, they damned well better be prepared to be taken over. The fact is that company after company can sit there poorly managed, not really doing the job that they want, and then suddenly raise the flag of desperation when someone comes in and says it is a public marketplace. There is no freer market than the stock markets.

If you sit there as a manager trying to husband your resources and keeping real estate and keeping mineral deposits and things of that nature, not employing it, so you have got a reserve one day when you need a quarter boost or an annual boost, I think that is a pretty poor test of the way management ought to operate.

I do not like takeovers where they dismantle a company, and so forth, but I also do not think any management team ought to be protected simply because they are sitting there and they are saying, look, I am what is good for the shareholders and the employees.

They are not doing the employees a bit of a favor if they do not employ those resources, make profits, expand the company, and search for new products. What I hear here constantly is, well, we have got to stop corporate takeovers. Stop corporate takeovers and you will increase the lazy factor in corporate management across this country.

FEDERAL FINES AND PENALTIES—ADJUST FOR INFLATION

I would like to just talk about a couple things, one relatively minor in total revenue effect. I would be curious about how you think we ought to deal with revenues derived from fines and penalties vis-a-vis inflation.

I introduced some legislation last year.

Secretary BAKER. Vis-a-vis what, Senator?

Senator **Lautenberg**. Fines and penalties. An OSHA penalty, for instance, in 1970 of $10,000 is still $10,000. If that were adjusted for inflation, it would be $27,000. An FAA penalty of $1,000 set in 1958—to adjust that for inflation would be $3,7O0, and there are many more examples.

Over 40 percent of the penalty levels in our agricultural laws have not been touched in 20 years or more. Does it make sense, do you think, to peg these penalties to inflation to keep abreast of changes in the buying power of the dollar?

Secretary **Baker**. No, sir, I was not aware of your legislation, but off the top of my head it sounds like an excellent idea to me. We have been jacking up the penalties in the Internal Revenue Code, as you know. I do not know why all penalties should not keep pace with inflation, why the Federal Government should pick up the tab for inflation for people who are breaking the law.

Senator **Lautenberg**. I would appreciate it if you could take a look at that.

FSLIC RECAPITALIZATION

Another thing that comes to mind is the FSLIC recapitalization. Now, we are concerned about the health of FSLIC. As a matter of fact, I think underlying that concern perhaps is even some concern about FDIC in terms of potential problems.

When I talk to the bankers, they say, well, it is selfliquidating, and so forth. I am not sure that that is going to be the case if what we see currently continues to happen.

How does the budget score the administration's recapitalization plan. It calls for a new financing facility that would borrow money and give the money to FSLIC in the form of purchase of their stock?

Now, I understand the new financing would be off—budget, but its payments to FSLIC would be on-budget.

Secretary **Baker**. It is my understanding that CBO has agreed with OMB that the payment into FSLIC will be a collection as opposed to a borrowing and will be good, therefore, from the standpoint of the budget.

Chairman **Chiles**. Do you believe that?

Secretary **Baker**. Yes; if that is the way OMB scores it and that is the way CBO scores it. They are the scorers, I am not, and their expertise in those matters is a lot better than mine. Yes, sir, I believe it.

Senator **Lautenberg**. There is a difference of a $1.6 billion. Senator Exon is the only one who smokes and others provide the mirrors.

CUSTOMS SERVICE FUNDING

Mr. Secretary, one last thing, and that has to do with the Customs Service, and I do not know whether it was raised before while I was out of the room. But we are dropping funding about $120 million in rough terms in fiscal year 1988.

What is the effect of these cuts? We are looking at collections, collections of tariffs. We need to collect every cent that is due us.

Customs money also helps us intercept contraband, drugs, et cetera.

Is there not an analogy, though, not in quite the same proportion, to IRS agents? You put them on and you get, supposedly, a better return. Of course, you could not put on 6 million agents in IRS and keep getting back five or six or four times your money.

But how about in Customs? There is a return on investment there that is pretty good and it helps us to protect this marketplace from illegal materials as well as counterfeit products.

Secretary **Baker**. Senator Lautenberg, there is some correlation. It is nowhere near as great as it is with respect to the Internal Revenue Service. Most of the increase in Customs revenues comes as a consequence of greater imports, and it is attributable to the dollar volume of imports rather than the number of Customs inspectors checking it out.

I do not have the exact figure for you, but it is nowhere near as great as the increase where you add IRS revenue agents.

Senator **Lautenberg**. Mr. Secretary, one of the things we read about in newspapers around some of the larger harbors in the country is that there is a lot of material that comes into the country without being inspected. We are talking about huge lots where they just do not have the capacity to do that job.

I think that that is a known problem, and I wish that we could get some information, you know, estimating what might happen in terms of the return on investment with additional Customs people, what kind of estimates there are for material on which tariffs are perhaps ignored, not collected.

Secretary **Baker**. Well, let me give you what the Department's figure is and at the same time say we will go back and take another closer look. Compliance with requirements to pay duties is estimated by the Department to be 95 percent, which is quite high, and that is why I say that there is a weak relationship between the size of the Customs commercial staff and the revenue that is collected by that commercial staff, quite different than in the case of IRS.

Senator **Lautenberg**. One thing we know is that imports are up substantially.

Secretary **Baker**. Imports are up significantly and Customs revenues are accordingly up.

Chairman **Chiles**. Senator Exon.

Senator **Exon**. Mr. Chairman, thank you very much. I suppose I am the last questioner. I want to thank you for the excellent job that I think you have done as the Secretary, and we look forward to working with you in the next couple of years.

STOCK MARKET GREEN MAIL

My friend from New Jersey just came to a defense of some of the practices on the stock market that I am very, very much concerned about. I guess maybe the closer you live and reside and have your business to Wall Street, the greater you think it is.

I have no quarrel at all with legitimate business activities, people buying stock for investment purposes. I happen to feel that the present frenzy and volume on the stock market is being driven other than by legitimate business interests.

I am shocked that we have not done anything about green mail. That does not do anybody any good and there is no way that green mail plays in my definition, and I believe strongly in the free enterprise system.

But this business of my buying out your corporation, supposedly, but not wanting to buy it out at all—all I am trying to do is to get you in the place where you have to come up with some green mail to pay me off so I will not take over your corporation—that is not, in my opinion, a legitimate function of the stock market.

Many, many employees have been hurt by that, as was the case with the recent activities and the attempt of a foreigner to buy out the Goodyear Corporation.

SPECULATION AND ERODING STOCK MARKET SAFEGUARDS

My particular question to you, Mr. Secretary, is: Are you concerned about another aspect of the stock market that people, that know much more about that than this Senator, are now concerned about, and that is the overspeculation and the somewhat eroding of the safeguards that were put in after the crash in 1929, driven to a considerable extent by the latest mania for betting on the levels of stocks in the future as far as speculation is concerned.

This must be something that your department has looked at from time to time. Do you feel that there is a serious eroding of the safeguards that we had in place and all this triple-witching and the things that we hear about today. That is not a legitimate function of the stock market, is it?

Secretary **Baker**. Senator Exon, I am really not. I have confessed to you that we have not, to my knowledge, in our department sat down and made a study of trading activity. I suppose you are talking about computerized program trading, and perhaps that would bear some looking at.

I am not entirely sure the Treasury Department is the department to look at it, and I rather suspect that the SEC has done some specific looking at it. I think the safeguards with respect to the market and the compliance measures and laws that are in force today are far greater than they used to be. It seems to me that what you have in this Boesky case is an example of the system working, at least in part.

Senator **Exon**. You do not think green mail is part of the system working, do you?

Secretary **Baker**. As I indicated earlier, we are taking a look once again at the issues of junk bonds, at the issues of green mail, at the issues of poison pill defenses and things like that, and I think such a look is well justified in light of what has happened.

Again, I think it is going to be very difficult to reach a policy determination until we know the full scope and extent of what might have gone on. I am not aware, in answer specifically to your question, of any studies we have done on the increase in trading activity on the stock exchanges, but we would not be the department that would normally be doing that. I am quite willing to have it reviewed by some of our people down there, and I would be glad to do so.

Senator EXON. Thank you. I appreciate that.

FOREIGN TAKEOVER OF SEMI-CONDUCTOR COMPANY

One last matter, I think, that I would like to bring up is on December 15, Mr. Secretary, I wrote you and had a reply back from one of your assistants that I would be getting a more detailed reply from you, but it has to do with a related matter of a takeover by Fujitsu, I believe it is, of Japan, of a very important semiconductor supplier as it affects our national defense establishment in the United States.

That has to do with their proposed purchase of 80 percent of Fairchild Semiconductor Industry. At the same time, I noticed, Mr. Secretary, that out of the Defense Department Advisory Committee comes a draft report that calls for $1.6 billion of Government assistance over 5 years to aid the ailing semiconductor industry in an effort to make them more competitive.

This seemed to me like a situation where the right hand does not know what the left hand is doing, and if you have not had a chance to look at this personally, I will understand.

Are you familiar with my letter and can you enlighten me at all as to whether or not there has been any decision on some of the activities that you have direct charge over with regard to whether or not we are going to allow Fujitsu to acquire Fairchild?

Secretary BAKER. Senator Exon, I cannot. I am sorry to say I have not specifically seen your letter, but there has been no action by the committee which is chaired by the Treasury Department respecting foreign direct investment in the United States. The matter is under review; it has been and it remains under review. Quite frankly, this particular committee will probably not be the one to examine the question of the national security implications of such an investment.

We think that this matter probably ought to be kicked up to the Economic Policy Council, so we will be taking a look at the question in that body, where the Defense Department and other national security agencies are resident.

Senator EXON. I have two concerns, not only as a member of this committee, but as a member of the Armed Services Committee, which does oversee the national policy interests of the United States.

Thank you very much, Mr. Secretary.

Secretary BAKER. Yes, sir, Senator.

Senator EXON. Thank you, Mr. Chairman.

[The following was subsequently supplied for the record by the Treasury Department:]

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

[illegible] JAN 1987

Dear Senator Exon:

Thank you for your letter of December 15, 1986 to Secretary Baker concerning Fujitsu Ltd.'s proposed investment in Fairchild Semiconductor Corp.

As you are aware, the Committee on Foreign Investment in the United States is reviewing the proposed investment. The members of the Committee are Treasury, State, Defense, Commerce, the U.S. Trade Representative, and the Council of Economic Advisors. Because the national security concerns of this transaction may affect the United States in several different ways, we have invited other agencies to participate in our discussions. These include the White House Office of Science and Technology Policy, the Justice Department, the National Science Foundation, and the Office of Management and Budget. In addition, we have met with senior representatives of Fairchild and Fujitsu to insure that we fully understand the facts relating to the transaction and to obtain information regarding the national security aspects of Fairchild's existing operation and the proposed new entity.

I can assure you that national security concerns are a major aspect of the CFIUS review and that the points made in your letter are being taken into account. Thank you again for bringing your views to our attention.

Sincerely,
MIKE HUDSON

J. Michael Hudson
Assistant Secretary
(Legislative Affairs)

The Honorable J. James Exon
United States Senate
Washington, D.C. 20510

J. JAMES EXON
NEBRASKA

86-17614

COMMITTEES:
ARMED SERVICES
COMMERCE SCIENCE AND
TRANSPORTATION
BUDGET

United States Senate
WASHINGTON, D.C. 20510

December 15, 1986

The Honorable James A. Baker, III
Secretary of the Treasury
15th & Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Secretary Baker:

I am writing to you in your capacity as the Chairman of the Committee on Foreign Investment in the United States.

I am extremely concerned over the national security implications of the proposed sale of 80% of Fairchild Semiconductor Corporation to Fujitsu LTD. of Japan. Semiconductors and related technology have helped the United States maintain its technological lead over the Soviet Union and the Communist bloc. However, that long-standing advantage is being challenged and, in some areas, eroded. It is imperative for our national defense and overall security that we maintain our existing advantages over the numerically-superior forces our potential enemies possess.

Fairchild is a major vendor of vital components to the U.S. Defense Department and the sole supplier of certain devices which are vital to important defense programs. As we strive to revitalise our defense-related industrial base, it would be a mistake of major proportions to allow more of that base to be under the control of foreign operations. While Japan is certainly a friend and ally, I believe this is a situation which surely warrants our government to examine all the ramifications of this proposed sale very carefully and to take action to preserve at least a minimum and prudent level of its vital defense industry within our borders and jurisdiction. Since the Japanese have such a greater involvement in high technology world-wide than do the French, the current French-based ownership of Fairchild poses much less a problem in this regard than the proposed sale to a Japanese-based concern.

I hope that you and your designee will use your position as the Chairman of the Committee on Foreign Investment in the United States to keep our national security requirements in the forefront of your deliberations as this proposal is considered.

With best wishes.

Sincerely,

J. James Exon
United States Senator

Chairman **Chiles**. Mr. Secretary, we want to thank you very much for your attendance and your patience in being with us. We think it was a very good hearing.

We will recess the hearing now.

Secretary **Baker**. Thank you, Mr. Chairman.

[Whereupon, at 12:35 p.m., the committee was adjourned.]

ECONOMICS

WEDNESDAY, JANUARY 28, 1987

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 2:00 p.m., in room SD-608, Dirksen Senate Office Building, Hon. Lawton Chiles (chairman of the committee) presiding.

Present: Senators Chiles, Lautenberg, Simon, Conrad, Domenici, Kasten, Danforth, and Rudman.

Staff present: Richard Brandon, staff director; and Alan Cohen, assistant director for budget priorities.

For the minority: G. William Hoagland, staff director; and Gail Fosler, deputy staff director and chief economist.

OPENING STATEMENT OF CHAIRMAN CHILES

Chairman CHILES. Dr. Penner, we welcome you to the Budget Committee, and we are delighted to have you here today. Your tenure as the Chief of the Congressional Budget Office has certainly not been easy.

We have had procedural changes, and changes in the Tax Code, and certainly, enormous pressure to reduce the deficit. Now, in the middle of all of this, we have another change. You have decided to change jobs and get the heck out of here. I sort of wish you would not do that. Things are tough enough for us the way they are, but we do certainly want to thank you for your services and the help that you have given us.

I think we have been very fortunate to have a CBO, and keep the professionalism, and the nonpartisan aspect of it. We will be wrestling now trying to find a new director, but you certainly have kept that professionalism in tact, and we are grateful for your efforts and ability.

Through all the turbulence you have held it together. Your office today can take pride in that professional objectivity, and you certainly deserve a lot of credit.

The standard of CBO is the index by which we measure all aspects of the budget. So, we certainly depend on you and you have not let us down.

Now, having said all those good things, you bring us the worst of all kind of news, and you are lucky it is not Greek times where they used to do away with the messenger.

The President has given us a budget he claims will reduce this huge deficit and get us down to $108 billion. But when we look at his deficit we see that he is proposing a number of spending cuts, 60 or 70 percent of them have been rejected before, and so we know we probably cannot get those. We also know that the President has proposed some revenues on his side, about $18 billion, they include "noncontroversial" things like a salt-water fishing license, and charging people to come into a national park, and some of those things that Congress will just race to embrace as revenue-raisers.

PRESIDENT'S BUDGET $30 BILLION SHORT

But on top of that, we now have you coming and giving us the worst of all news. The President's budget is $30 billion short.

We find ourselves now hoisted on the petard of the fact that we have used CBO over the years. As a Democrat, we have protested a couple of times that our colleagues did not want to use your numbers and so now we are sort of locked in. We are going to have to use your numbers, unless you tell us you can recant, that you have erred, and that the President's budget really does meet the targets. Hopefully, you can tell us whether yours is a middle-of-the-road forecast, or that you are giving us the worst-case scenario. But if CBO is really telling us the deficit is $30 billion higher, that certainly gives us a problem. So, if there is some way you can make life easier for us, we would like to hear it. We thank you. Senator Domenici is on his way here, and he may have some opening remarks later. Is there anybody else? Well, then, we will call on you for your statement.

I have mentioned to you that we are going to have a vote at 2:30.

STATEMENT OF DR. RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. PENNER. Thank you very much, Mr. Chairman, especially for your kind words in the beginning. I have enjoyed working with you, Senator Domenici, and the other members of this committee through what, as you said, were some difficult times. I have always been very appreciative of the way that you have approached CBO, given us our independence, and let us "do our thing," though, as you say, sometimes the results were painful to you.

I am pleased to be here today to discuss the CBO economic and budget projections which are described in detail in our annual report.

CBO'S ECONOMIC AND BUDGET PROJECTIONS

The CBO projects that, under current taxing and spending policies, the Federal deficit will decline from its record high of $221 billion in 1986 to $174 billion in 1987, $169 billion in 1988, and $85 billion in 1992. In relation to the gross national product (GNP), the deficit is projected to decline from 5.3 percent of GNP in 1986 to 3.6 percent in 1988, and 1.4 percent in 1992.

These budget projections are contingent on CBO's forecast of a moderate pickup in economic growth from its subdued pace in 1986, and a modest decline in both short-term and long-term interest rates over the projection period from their average levels in 1986. They also assume that both defense and nondefense discretionary appropriations are held to zero real growth. The budgetary outlook and the economic assumptions underlying the forecast are presented in Table 1 of my testimony.[1]

The economic expansion has now entered its fifth year. Over the four quarters of 1986, the economy grew at a 2.5 percent rate, about the same as in 1985 but substantially below its growth for the first 2 years of recovery. Unemployment in 1986 was slightly below that of 1985 but still averaged 7 percent. Total employment grew rapidly, however, by about 2.3 percent. Most of the new jobs were in the service-producing sector. There was a continuing weakness in employment growth in the goods-producing sector, at least partially attributable to the widening trade deficit. Inflation decreased in 1986, especially as measured by the Consumer Price Index (CPI), largely because of the precipitous decline in oil prices at the beginning of the year. Despite the continuing depreciation of the dollar against most currencies, prices of imports did not move up as sharply as many forecasters had anticipated, nor did the import surplus decline as had been expected.

Interest rates—especially long-term rates—fell considerably as a result of the easing of inflation, the sluggish growth of the economy, and the expectation of lower Federal deficits.

CBO forecasts a moderate pickup in economic activity in 1987 and 1988. Real GNP is expected to grow just under 3 percent annually, which should bring the unemployment rate down to an average of 6.6 percent in 1987 and 6.5 percent in 1988.

CBO FORECAST RISE IN INFLATION

Like most other forecasters, CBO anticipates that the trade sector will be the major contributor to stronger growth.

CBO's forecast calls for a rise in reported inflation between 2 and 2.5 percent in 1986 to about 3.7 percent in 1987–1988 (as measured by the implicit GNP deflator). On the consumer level, CBO sees inflation rising even more sharply from the artificially depressed rate of about 1.5 percent in 1986 to almost 4.5 percent in 1987 and 1988. The rise in inflation will reflect, among other things, somewhat higher oil prices and rising import prices caused by the falling dollar. Nominal interest rates in 1987 and 1988 are expected to stay about their present levels.

Under these economic assumptions, CBO projects a sharp decline of the baseline budget deficit in 1987 and a further moderate reduction in 1988. About half of the expected decline in the 1987 deficit results from one-time factors, including an increase in revenues under the Tax Reform Act of 1986, asset sales, and shifts of outlays into adjacent years. After 1987, revenues under current laws are projected to grow at an annual rate of nearly 8 percent—slightly faster than GNP—while baseline outlays grow only 5 percent a year, which is substantially below the 10 percent annual growth rate experienced earlier in the 1980's and less than the projected growth in the economy (see Figure 1, p. 202.)

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[1] See p. 200.

DEFICITS EXCEED TARGETS

Baseline budget deficits, although declining through the projection period, exceed by large amounts the targets established by the Balanced Budget Act. The 1988 deficit would have to be cut $61 billion below the baseline in order to reach the goal of $108 billion. For fiscal years 1989 through 1991, the baseline deficit averages about $100 billion over the statutory targets (see Table 1, p. 200.)

Mr. Chairman, the rest of my testimony goes into these things in more detail. With your permission, I would like to submit it for the record and take your questions.

[The prepared statement of Dr. Penner follows:]

Statement of
Rudolph G. Penner
Director
Congressional Budget Office

before the
Committee on the Budget
United States Senate

January 28, 1987

Mr. Chairman, I am pleased to appear before you today. I will be discussing the economic and budget projections of the Congressional Budget Office (CBO) which were described in detail in the CBO report titled *The Economic and Budget Outlook: Fiscal Years 1988-1992*, and released last week. In my testimony this afternoon, I will discuss:

- The economic forecast for 1987 and 1988 and projections for 1989-1992; and
- The CBO baseline budget projection, and how it compares with the CBO projection made last August and with the deficit targets of the Balanced Budget and Emergency Deficit Control Act of 1985.

CBO'S ECONOMIC AND BUDGET PROJECTIONS

The Congressional Budget Office projects that, under current taxing and spending policies, the federal deficit will decline from its record high of $221 billion in 1986 to $174 billion in 1987, $169 billion in 1988, and $85 billion in 1992. In relation to gross national product (GNP), the deficit is projected to decline from 5.3 percent of GNP in 1986 to 3.6 percent in 1988 and 1.4 percent in 1992.

These budget projections are contingent on CBO's forecast of a moderate pickup in economic growth from its subdued pace in 1986, and a modest decline in both short-term and long-term interest rates over the projection period from their average levels in 1986. They also assume that both defense and nondefense discretionary appropriations are held to zero real growth. The budgetary outlook and the economic assumptions underlying the forecast are presented in Table 1.

The economic expansion has now entered its fifth year. Over the four quarters of 1986, the economy grew at a 2½ percent rate--about the same as in 1985 but substantially below its growth in the first two years of recovery. Unemployment in 1986 was slightly below that of 1985 but still averaged 7.0 percent. Total employment grew rapidly, however, by about 2.3 percent. Most of the new jobs were still in the service-producing sector. There was a continuing weakness in employment growth in the goods-producing sector, at least partially attributable to the widening trade deficit. Inflation decreased in 1986, especially as measured by the Consumer Price Index (CPI), largely because of the precipitous decline in oil prices at the beginning of the year. Despite the continuing depreciation of the dollar against most other currencies, prices of imports did not move up as sharply as many forecasters had anticipated, nor did the import surplus decline as had been expected. Interest rates--especially long-term rates--fell considerably as a result of the easing of inflation, the sluggish growth of the economy, and the expectation of lower federal deficits.

CBO forecasts a moderate pickup in economic activity in 1987 and 1988. Real GNP is expected to grow just under 3 percent annually, which should bring unemployment down to an average of 6.6 percent in 1987 and

TABLE 1. BASELINE BUDGET PROJECTIONS, DEFICIT TARGETS, AND UNDERLYING ECONOMIC ASSUMPTIONS

	Actual	Projected					
	1986 a/	1987	1988	1989	1990	1991	1992
Budget Projections (By fiscal year, in billions of dollars) b/							
Baseline Estimates							
Revenues	769	834	900	962	1,050	1,138	1,220
Outlays	990	1,008	1,069	1,124	1,184	1,247	1,305
Deficit	221	174	169	162	134	109	85
Deficit Targets	172	144	108	72	36	0	n.a.
Baseline Less Targets	49	30	61	90	98	109	n.a.
Economic Assumptions (By calendar year)							
Nominal GNP (percent change)	5.4	6.0	6.9	7.2	7.4	7.0	6.8
Real GNP (percent change)	2.6	2.8	3.0	3.0	3.1	2.7	2.5
CPI-W (percent change)	1.6	3.5	4.3	4.3	4.3	4.3	4.3
Civilian Unemployment Rate (percent)	7.0	6.6	6.5	6.3	6.1	6.0	6.0
Three-Month Treasury Bill Rate (percent)	6.0	5.6	5.7	5.6	5.5	5.3	5.2

SOURCE: Congressional Budget Office

NOTE: n.a. = not applicable.

a. 1986 data for nominal and real GNP and the CPI-W are CBO estimates. The estimates do not reflect the actual data for the fourth quarter of 1986 that were released on January 22, 1987.

b. The baseline estimates and deficit targets include Social Security, which is off-budget.

6.5 percent in 1988. Like most other forecasters, CBO anticipates that the trade sector will be the major contributor to the stronger growth.

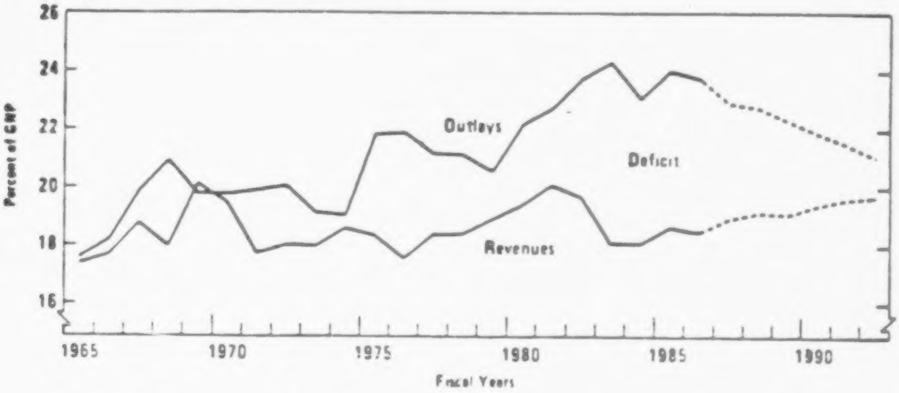
CBO's forecast calls for a rise in reported inflation, between 2 percent and 2½ percent in 1986 (as measured by the implicit GNP deflator) to about 3.7 percent in 1987-1988. On the consumer level, CBO sees inflation rising even more sharply--from the artificially depressed rate of about 1½ percent in 1986 to almost 4½ percent in 1987 and 1988. The rise in inflation will reflect, among other things, somewhat higher oil prices and rising import prices caused by the falling dollar. Nominal interest rates in 1987 and 1988 are expected to stay at about their present levels.

Under these economic assumptions, CBO projects a sharp decline of the baseline budget deficit in 1987 and a further moderate reduction in 1988. About half of the expected decline in the 1987 deficit results from one-time factors, including an increase in revenues under the Tax Reform Act of 1986, asset sales, and shifts of outlays into adjacent years. After 1987, revenues under current laws are projected to grow at an annual rate of nearly 8 percent--slightly faster than GNP--while baseline outlays grow only 5 percent per year, which is substantially below the 10 percent annual growth rate experienced earlier in the 1980s and less than the projected growth in the economy (see Figure 1).

Baseline budget deficits, although declining throughout the projection period, exceed by large amounts the targets established by the Balanced Budget Act. The 1988 deficit would have to be cut $61 billion below the

FIGURE 1.

Baseline Revenues and Outlays



SOURCES: Congressional Budget Office; Office of Management and Budget; Department of Commerce, Bureau of Economic Analysis.

baseline in order to reach the goal of $108 billion. For fiscal years 1989 through 1991, the baseline deficit averages about $100 billion over the statutory targets (see Table 1).

THE ECONOMIC OUTLOOK

Economic growth in 1986 turned out to be weaker than most forecasters had anticipated, mainly because of sluggishness in the manufacturing sector. Domestic demand remained fairly strong, growing about one percentage point faster than output. Growth of personal consumption, which accounts for about 65 percent of GNP, was faster than in the preceding year.

Residential construction was also stronger than in 1985. Business fixed investment, however, contracted during the year. Most important, real net exports continued their rapid deterioration; the widening of the trade deficit accounted for the divergence between the fairly strong growth of domestic demand and the weak growth of output.

While the trade picture at year-end remained bleak, import prices had begun to respond to the prolonged and substantial depreciation of the dollar against major foreign currencies. This rise in import prices suggests that the decline in real net exports is likely to bottom out in the first half of 1987. Also, as the federal budget deficits begin to contract in 1987 and beyond, the demand for real credit should decline, thus discouraging net international capital inflows. These developments should lead to further depreciation of the dollar--as expected by CBO--and, in time, should further improve our trade deficit.

Prospects for other components of demand are less buoyant. Business fixed investment is expected to remain lackluster, while growth in consumer spending, residential construction, and government purchases of goods and services is expected to be slower in 1987 than last year.

On the plus side, the difficulties in the manufacturing sector seemed to lessen toward the end of the year, as indexes of industrial activity began pointing toward better times ahead. The rebound in oil prices in the second half of 1986 helped stem the decline in activity in the oil industry and its suppliers, although higher oil prices will be costly for the economy in the longer run.

CBO's economic projection consists of two parts: a short-term forecast of economic conditions through 1988 contingent on specific policy and other crucial assumptions; and a medium-term projection for the period 1989 through 1992 based on historical trends and other assumptions about economic growth.

The Forecast for 1987-1988

CBO's two-year forecast, presented in Table 2, is based on the following assumptions as to fiscal and monetary policy:

- Federal budget policies for fiscal year 1988 are assumed to be consistent with achieving the deficit targets specified in the Balanced Budget Act. Since the policies for that year are not known, CBO assumes equal across-the-board revenue increases and spending cuts, after incorporating an estimate for asset sales.
- The Federal Reserve Board is assumed to pursue a policy that would allow the monetary aggregate M2 to remain within its target range.

In addition, the forecast assumes that:

- The world price of oil will be close to $15 per barrel through the end of 1988.
- By the end of 1988, the exchange rate (as measured by the Federal Reserve Board index) will be about 10 percent below its level at the end of 1986.
- Food prices will rise by about 4 percent throughout the forecast period.

Given these assumptions, CBO expects real GNP to grow at about a 3 percent annual rate between the fourth quarters of 1986 and 1988, a bit faster than over the last two years. Inflation at the consumer level will rise to around 4½ percent in 1987-1988 from its exceptionally low level in 1986. Civilian unemployment is forecast to average 6.6 percent in 1987, and to

TABLE 2. THE CBO FORECAST FOR 1987 AND 1988

	Actual		Forecast	
	1985	1986 a/	1987	1988
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	6.3	5.1	6.5	7.1
Real GNP	2.9	2.5	3.0	2.9
Implicit GNP Deflator	3.3	2.6	3.4	4.0
CPI-W	3.2	1.1	4.4	4.4
Calendar-Year Averages (percent)				
Unemployment Rate	7.2	7.0	6.6	6.5
Three-Month Treasury Bill Rate	7.5	6.0	5.6	5.7
Ten-Year Government Bond Rate	10.6	7.7	7.2	7.2

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics.

a. 1986 data for nominal and real GNP and the CPI-W are CBO estimates. The estimates do not reflect the actual data for the fourth quarter of 1986 that were released on January 22, 1987.

drop further in 1988 to around 6.5 percent. The interest rate on three-month Treasury bills should rise slightly in 1987 from current levels, while yields on 10-year Treasury bonds are expected to remain at their current levels.

Medium-Term Economic Projections

CBO's medium-term projections for 1989 through 1992 are not a forecast of economic conditions, but projections based on historical experience. These out-year economic projections are not predicated on specific budget policies, and may not be consistent with the budget policies now in place. Real GNP is assumed to grow at about its post-war historical average until 1990. Thereafter, it is equal to CBO's projection of potential GNP. The projections of potential GNP thus plays a central role in CBO's economic projections. We have recently revised downward the projection of potential GNP, and thus of long-term growth. The reasons are discussed in Chapter 3 of our report.

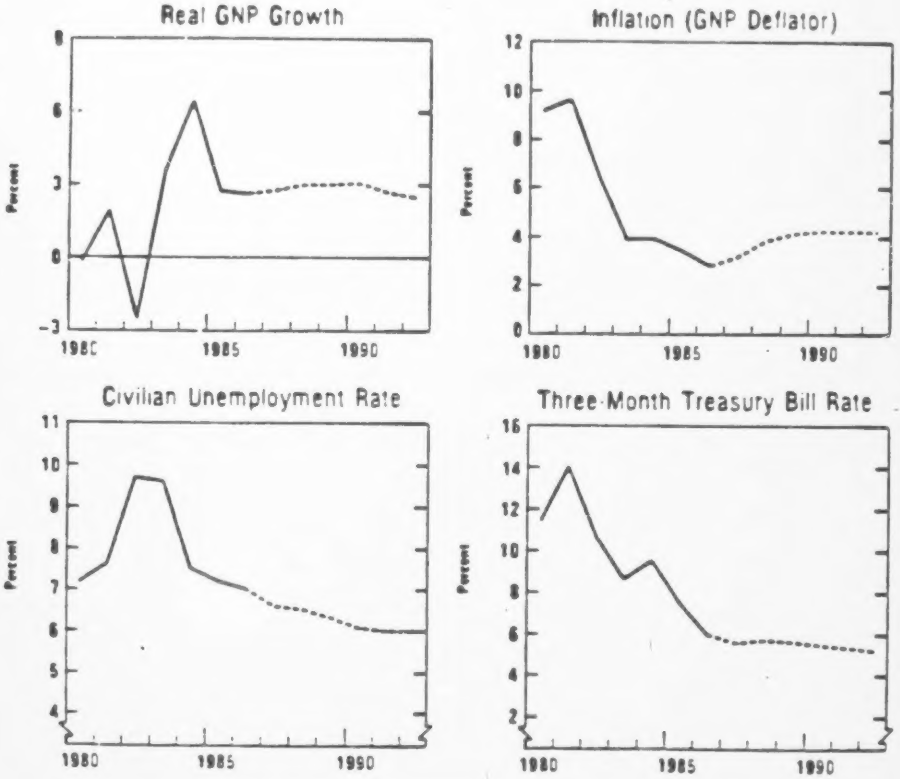
The major characteristics of the 1989-1992 projections are shown in Figure 2.

- Real GNP grows at an average rate of 2.7 percent.
- Unemployment declines to about 6 percent in 1990 and remains near this level in subsequent years.
- Inflation, as measured by the CPI-W, holds at 4.3 percent throughout the projection period.

- Nominal interest rates on short-term Treasury bills decline gradually to 5.2 percent by 1992, while rates on long-term Treasury bonds decline a bit more sharply to 5.6 percent by the end of the projection period.

FIGURE 2.

Major Economic Assumptions



Real GNP Growth

Inflation (GNP Deflator)

Civilian Unemployment Rate

Three-Month Treasury Bill Rate

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Uncertainty in the Outlook

While every economic forecast is subject to great uncertainty, a number of special factors combine to render forecasts made at this time particularly uncertain. For example:

- The impact on the economy of the shift in fiscal policy toward greater restraint, as mandated by the Balanced Budget Act;
- The economic impact of the Tax Reform Act of 1986, which changes the composition of federal receipts and substantially alters incentives for many economic activities;
- The ability of OPEC oil producers to maintain oil prices at their current levels; and
- The speed and strength of the response of exports and imports to the dollar depreciation.

THE BUDGET OUTLOOK

CBO's baseline budget projections reflect the new economic forecast and medium-term projections, the latest information on tax collections and spending patterns, and estimates of the effect of recently enacted legislation. As they did last year, the projections assume that both defense and nondefense discretionary appropriations are held constant in real terms and that current tax and entitlement laws are not changed. Under these assumptions, the deficit, as I mentioned earlier, is projected to decline from $221 billion in 1986 to $85 billion in 1992 (see Table 1).

The 1988 baseline deficit of $169 billion exceeds the Balanced Budget Act's target by $61 billion. The deficit targets decline at a faster rate than the baseline in future years so that the gap between the baseline and the annual deficit targets grows to $109 billion by 1991. Under the Balanced Budget Act, the Congress could choose to meet the 1988 deficit target by across-the-board spending cuts referred to as sequestration. Under CBO's baseline assumptions, these cuts would have to be 14 percent for defense programs and 20 percent for nondefense programs from 1987 appropriation levels.

As the result of continuing budget deficits, debt held by the public is projected to grow from $1.7 trillion at the end of 1986 to over $2.5 trillion by the end of fiscal year 1992. The federal government's debt has grown faster than the economy since the early 1980s, but CBO's baseline projections of declining deficits show an end to this trend. The ratio of debt to GNP under CBO's baseline assumptions peaks at 44 percent in the 1988-1990 period and then falls to 41 percent in 1992--very close to its current level (see Figure 3). The decline in the debt-to-GNP ratio will obviously be sharper if the deficit targets of the Balanced Budget Act are met.

Changes in Baseline Projections

Projected baseline deficits for 1988-1991 are higher than projected by CBO last August despite the enactment of legislation in October to reduce spending and increase revenues. Under CBO's August 1986 economic and technical assumptions, the Omnibus Budget Reconciliation Act, the Tax Reform Act, and the continuing resolution for appropriations would have reduced the 1987 deficit to about $151 billion--within $10 billion of the Balanced Budget Act's target. But CBO's new economic and technical assumptions raise the 1987 deficit estimate to $174 billion. Moreover, most of the budgetary savings from enacted legislation last year were one-time savings. While the savings attributable to legislation were $32 billion in 1987, the annual savings average only $6 billion in 1988-1991 (see Table 3).

Revised economic assumptions add to the deficit by amounts growing from $10 billion in 1987 to $25 billion by 1991. Lower levels of nominal GNP and changes in the composition of national income cause estimated revenues to be lower by amounts growing from $13 billion in 1987 to

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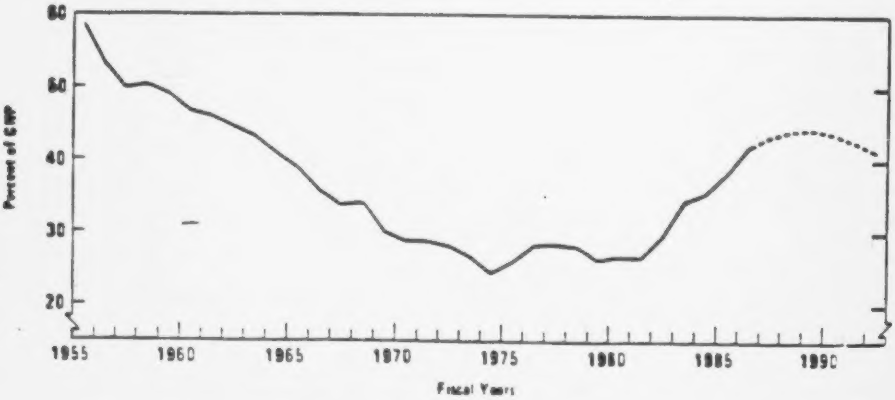
FIGURE 3.

Federal Debt Held by the Public



SOURCES: Congressional Budget Office, Office of Management and Budget, Department of the Treasury, Department of Commerce, Bureau of Economic Analysis.

NOTE: The values shown for the 1987-1992 fiscal years are consistent with the CBO baseline.

$22 billion in 1991. Lower projected interest rates, however, reduce debt-service costs and attenuate somewhat the budgetary effect of lower revenues.

Technical reestimates, primarily on the spending side, increase the projected deficits substantially in all years. Medicaid and Medicare spending in 1986 exceeded expectations; this growth is expected to continue, adding $3 billion to spending in 1987 and $7 billion by 1991. Changes in the outlook for U.S. agricultural exports and other factors increase outlays for farm price supports by $3 billion in 1987 and about $6 billion per year in the 1988-1991 period. Revised defense spending estimates add less than

TABLE 3. CHANGES FROM CBO AUGUST BASELINE DEFICIT PROJECTIONS (By fiscal year, in billions of dollars)

	1987	1988	1989	1990	1991
CBO August 1986 Baseline Deficit	184	150	127	96	69
Enacted legislation	-32	-9	a/	-5	-10
Revised economic assumptions	10	11	15	19	25
Technical reestimates	13	17	20	24	25
CBO January 1987 Baseline Deficit	174	169	162	134	109

SOURCE: Congressional Budget Office.

a. Less than $500 million.

$1 billion to 1987 outlays but about $3 billion per year thereafter. Projected outlays have also risen by an average of $1½ billion per year for unemployment compensation and $1 billion per year for assistance payments and Supplemental Security Income. Those increases reflect recent spending experience. Finally, based on spending plans of the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation, estimated federal assistance to troubled financial institutions will grow by more than $4 billion in 1987.

Uncertainty of Budget Estimates

The changes in the baseline deficit projections because of revised economic assumptions and technical reestimates demonstrate the uncertainty of budget estimates. Relatively small changes in forecasts of outlays and receipts can result in a large percentage change in a deficit estimate. For example, a 1 percent increase in estimated outlays combined with a 1 percent reduction in estimated receipts would raise the estimated 1988 deficit by $20 billion or 12 percent. Finding another $20 billion of program cuts or tax increases is immensely difficult, and thus changes in budget estimates that seem small to a forecaster become extremely important politically.

Changes in the magnitude described above can result from very small changes in the economic outlook. For example, a one-percentage-point increase in the interest rate on the government debt would increase outlays by $11 billion in 1988 and $26 billion in 1992.

Significant changes in the estimates can also occur for reasons unrelated to the health of the overall economy. For example, unexpected increases in the cost of farm price supports, federal health programs, financial deposit insurance programs, and unemployment compensation have added $12 billion to CBO's estimate of the 1987 deficit since last August. In recent years, errors in technical estimating assumptions have caused the targets in first Congressional budget resolutions to differ from actual deficits by an average of $17 billion.

Chairman CHILES. Thank you very much. Senator Domenici, you got here just a little bit late. I will call on you now.

Senator DOMENICI. Let me ask, Mr. Chairman—I sent word that I could not be here for the opening——

Chairman CHILES. Yes.

Senator DOMENICI [continuing]. Did you have opening remarks?

Chairman CHILES. I made just a few.

Senator DOMENICI. Instead of asking questions, could I just take a few moments for an opening statement then I will yield for the first round of questions.

Chairman CHILES. Surely.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. First, Dr. Penner, I understand that while we are welcoming you here today, it may be your last official appearance. You have been a good CBO director, and I want to congratulate you.

I do not know why you are leaving. At one point I thought maybe you might be leaving because you thought the job of deficit reduction was all over with. [Laughter.]

I heard you started speaking about that around the country. But whatever the reason, I think you would agree that we have made some progress. I hope that before we are finished you will give us some of your views on reforming the process, including the 2-year appropriating and budgeting process.

ESTIMATING PROBLEMS

I would like to take this opportunity to make an observation with reference to the Federal budget, and estimating. Let me put this whole thing in perspective.

The President of the United States sent us a budget. While it was not totally backed up with every document, and everybody knew that, because it was too early, he said, through his experts, that the budget would yield a $108 billion deficit.

You were asked to give a preliminary re-estimate of those programs and CBO's your best estimate of economic assumptions. CBO has completed a preliminary analysis of the President's budget.

You said he is off the mark by anywhere from $27 to $34 billion, I think, depending upon some parameters. But let me put this specter of estimating into another perspective.

Just a few months ago, my friend from Florida and I went to the floor of the Senate, and while neither of us was terribly pleased, he being perhaps less pleased than I, we produced the budget package and a big old resolution that had all the appropriations in it. We asked CBO, "What will the deficit be?" And I think you said $150.6 billion in the year we are now living in.

If I am wrong with any of these you tell me, but I think it is pretty close.

Now we are told that we were off by a pretty big amount. You are telling us now the deficit is $174.5, billion, I think. We have not spent one additional dollar. We have not yet had a new appropriation bill. We may soon have some. But we have not yet had any.

And I think you are saying we are off $24-plus billion because we cannot estimate as well as we hoped, and we are bringing those estimating models and expenditure estimates more up-to-date with the passage of time.

Now, frankly, that disturbs me just as one Senator, and one who is a part of this process, just about as much as apparently the President's errors in his budget disturbed the other side.

You are saying he is off, but basically, well over half of the President's shortfall is because you do not agree with his assumptions. But CBO would still reestimate by $20-plus billion with no assumptions changed.

You say there is more unemployment money but you have not changed the unemployment rate assumption. You have merely said the models are incorporating more current data.

You have not changed Medicare inflation as I understand it; you have merely said it is going to spend more. Now if I am wrong on any of these, you tell me.

But clearly, we need to do better at estimating. In you parting remarks, I hope you will tell us how we might do better.

Do we need to spend some money on these models with the new man who takes your place? Do we need to have some kind of high, level conference on how we make these big tough estimates on outlays? Or are we going to be $20 to $45 billion off under anyone's estimating, 5, 6, 7, 8 months after we have passed the appropriations and finish our years' business?

That really is all I wanted to say. That is my opening statement, and I do not insist that you answer any questions yet. I will ask them again later. So I will yield, now, back to the chairman.

Chairman CHILES. I think I will yield at this time to——

Senator SIMON. I wonder if Dr. Penner wants to respond to the earlier question.

Chairman CHILES. Well, sure, we will let you comment on that, if you want to, Dr. Penner.

ESTIMATION ERRORS TRIVIAL

Dr. PENNER. Long before I came to CBO, I was concerned about the degree to which the regular budget process (and later the Balanced Budget Act process) depends on the use of very precise numerical estimates. There is a complete disjoint, as it were, between what might be called regular forecasting errors, those ordinary forecasting errors that you can expect as a matter of course—and the political importance of those errors. If we can forecast outlays within 1 percent, I would suggest that we have done a very good job, and I'm skeptical that any amount of money that you would spend, or improvement in the models that you might make, would do much better than that in the foreseeable future.

Obviously, a 1 percent error in forecasting outlays with a trillion dollar budget is $10 billion. A 1 percent error on the revenue side is almost $10 billion. If those two errors go in different directions there will be a $20 billion difference in the estimate of the deficit. Twenty billion dollars is a huge amount to cut from the budget, an amount, of enormous political significance, and yet, from the forecasting profession's point of view, it stems from trivial errors.

Thus, CBO's preliminary outlay and revenue estimates of the President's budget for fiscal year 1988 differs from the administration's by less than 2 percent, a very small amount. But, as we go through the arithmetic of the cuts needed to meet a specific deficit target, that small amount translates into an 80-percent difference. So, again, a trivial difference at the beginning expands by the way we do the arithmetic into a matter of huge political importance.

I have given an enormous amount of thought to these problems. Before I came to CBO, I even thought I might have some solutions. They essentially involved working out a unified set of economic assumptions between the Congress and the administration—assumptions that would be labeled as fairly arbitrary. But having been at CBO, I do not think that this process would work very well. I am not sure how you would achieve such agreement with different administrations. I am afraid it is a basic problem of the budget process—one we will have to live with. I think we must understand that forecasting is not an exact science, to say the least. The record is really pretty grim over the years.

CBO 1987 ESTIMATES AVERAGE OF FORECASTERS

Chairman CHILES. After listening to what Senator Domenici has had to say, can you give us some kind of feeling as to whether you think you are in the middle-of-the-road in your forecast or, has the President taken one whole spectrum and you have gone totally in the opposite direction? Is yours a middle-of-the-road forecast, and do we have to worry some about whether you are too optimistic?

Dr. PENNER. I can answer that by comparing CBO's forecast to some private forecasts which, Lord knows, could certainly be way off, too. The so-called "blue chip consensus"—that is, a group that considers a large array of forecasts and averages them—predicts economic growth of 2.4 percent for 1987 and 3.3 percent for 1988. CBO predicts 2.8 percent for 1987 and 3.0 percent for 1988, so we are very close; we are a little higher in the short run, a little lower in the longer run. We end up about the same place in 1988.

Some forecasts that are higher than ours, such as Wharton with 2.7 percent growth in 1987 and 3.8 percent in 1988 and Ray Fare at Princeton whose forecast is above that of the administration. Within a very wide range of forecasts, CBO is about, roughly speaking, in the middle of the eminent private forecasters.

Chairman CHILES. Senator Conrad.

Senator CONRAD. Dr. Penner, regarding the estimate that you have given us for the deficit in this year, $174 billion, or what is your analysis of what this deficit means to our ability to compete and the effect on the trade deficit?

Have you done an analysis of that correlation, that connection?

Dr. PENNER. With your permission, sir, before I answer you, let me comment on the other part of Senator Domenici's question about how we got from $151 billion to $174.5 billion—something that surprised us greatly, believe me.

Senator DOMENICI. Mr. Chairman, that should not be on his time.

Chairman CHILES. No, we will not count that.

EXPLANATION OF LARGE ESTIMATE CHANGE

Dr. **Penner**. A fairly small change in the economic assumptions is worth about $10 billion of that. We also had an extraordinary array of small increased costs in a number of programs—including agriculture, FDIC, FSLIC, medicare, and medicaid. Only one change—the increase cost—went in the other director and that was not enough to offset the increases. Usually good forecasters are good because they are lucky, and various errors cancel out.

Again I emphasize that the very large change in the deficit amount resulted from a change in the outlays and revenues amount of just marginally above 1 percent each. In forecasting two very large numbers, tiny errors can mean huge percentage errors in estimating the difference between the two very large numbers. That is the essence of the arithmetic problem we face. We do not forecast deficits. We forecast expenditures; we forecast receipts.

LINK BETWEEN BIG DEFICITS AND TRADE IMBALANCES

Turning to Senator Conrad's question, we do believe that there is a very close relationship between the size of the budget deficit and the size of the trade deficit. In CBO's views, this relationship is structured in the following way:

(1) The budget deficit puts upward pressure on U.S. interest rates; (2) higher interest rates make the United States a more attractive place for international capitalists to invest; (3) to invest, they must buy dollars; and (4) these purchaser drive up the value of the dollar, thus making it harder for the United States to compete in world markets.

You can create models in which that relationship is absolutely perfect. CBO, however, does not believe it is absolutely perfect. We think there is slippage in it. Sometimes there are time lags. But I believe very strongly that there is a strong linkage.

SOCIAL SECURITY AND DEFICITS

Senator **Conrad**. Let me just follow up by asking, looking at your on-budget baseline, we are talking about budget deficits in the $200 billion range until 1992, when we go down to $160 billion, if we deal with the social security question. In other words, if we are——

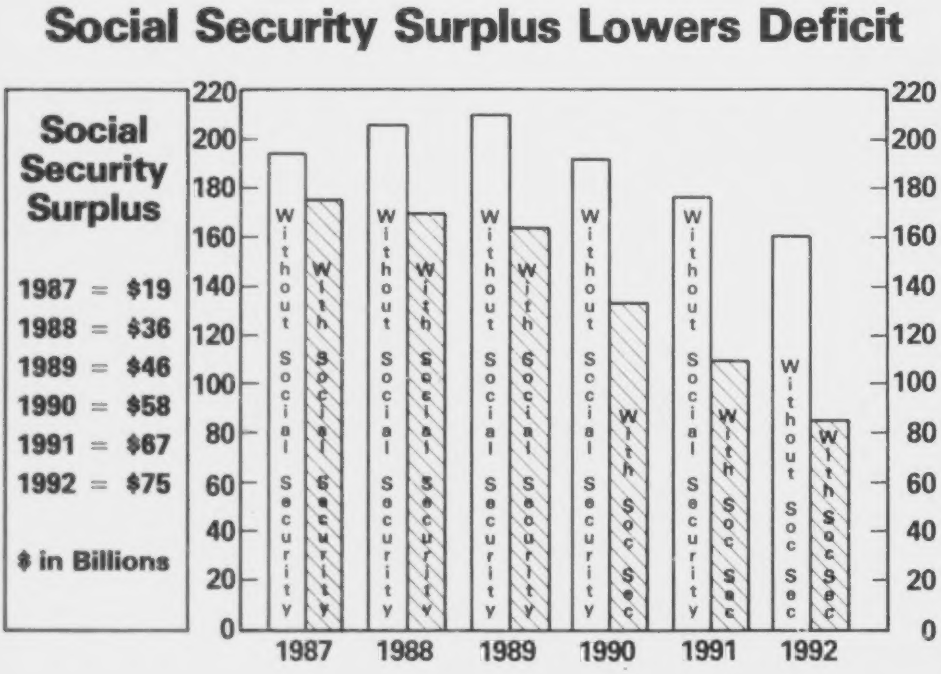
Dr. **Penner**. You are taking social security out of it?

Senator **Conrad**. That is right. Is that correct? I mean, is that a correct statement of your analysis? We are talking about——

Dr. **Penner**. Yes, sir.

Senator **Conrad** [continuing]. Baseline budget deficits, excluding social security, $200 billion a year. When we get out to 1992 we are down to $160 billion.

Chairman **Chiles**. We have got a chart that might help you look at that, or, Rudy, you might be able to use that chart to answer.



Prepared By Senate Budget Committee Staff, January 27, 1987

Dr. Penner. Yes. Those are the numbers. Right.

DEFICIT CONTROL NEEDS STRUCTURAL CHANGES

Senator Conrad. That is a pretty alarming chart to those of us who are committed to getting to a balanced budget by 1992. Some of us would like to see it much earlier.

Let me ask you: is it your conclusion—I mean, if you were sitting in our shoes, and you were sincerely interested, believed it was in the national interest to get to a balanced budget as quickly as possible—would it be your conclusion that the only way that is going to happen, given those numbers, is that there have got to be some major structural changes in the way we do business around here?

Dr. Penner. Let me make a couple of comments, sir. First of all, I think that one reason we are very interested in the deficit is because of how much we have to borrow from the public in order to finance it. And I think when you ask that question, you should include the social security surplus as funding that helps finance the other areas of government, thus making it possible to issue less Treasury debt. So the picture, as the chart shows, is much prettier with social security included.

In answer to your second question, if, by structural reforms, you mean changes in the process——

REVENUE AND SPENDING CHANGES NEEDED

Senator Conrad. No; I do not mean that. I mean something like a very dramatic break from the underlying assumptions of spending and revenue that are in current budgets.

For example, a very clear message to our friends in Japan and Western Europe, that we simply cannot provide for their defense umbrella anymore. Some very fundamental structural change in the underlying assumptions of our spending. Absent that, given these numbers, I do not see how we get to a balanced budget any day soon.

Dr. **Penner**. I think you make a good point. Looking at it in a different way our revenues now are only covering about 83 percent of our outlays. So, on the one hand, you can talk about a 17-percent cut in outlays, which is huge, and necessitates a change in various assumptions about funding programs, or you can think of almost a 20-percent increase in all revenue again a huge change, either of these actions would qualify as a major structural change by anybody's definition.

I do think that this country has been engaged in a discussion of the structure of government, and that is why it is so hard to control the deficit. The debate has been, very loosely speaking, between people who think spending is just about right, and taxes should be raised to cover it, and people who think that the government is too big and that the deficit problem should be solved by cutting spending. That is a very profound ideological debate, a complicated debate.

As Senator Domenici noted before, I think we have made considerable progress—not enough to satisfy anybody, but progress. I was looking at our baseline of 2 years ago, and then estimated the baseline deficit for fiscal 1988 was $249 billion; today it is estimated to be $169 billion. An enormous number of things have changed, the assumptions and so on—but I think most of those factors cancel out. So that is a big change. I would even call that something of a structural change, but as——

Senator **Conrad**. But I am talking about from here forward.

Dr. **Penner**. Yes; I understand that.

Senator **Conrad**. In order to get us home—I mean, some of us would like to see a balanced budget in 3 years, at the outside, 1992. But it is not going to happen, absent a major structural change, is it?

It is not going to happen, given these numbers, absent some major structural change, or a series of them?

Dr. **Penner**. You are talking of quite large changes in our national policy, one way or the other. Yes, sir.

Chairman **Chiles**. Senator Rudman.

Senator **Rudman**. Thank you, Mr. Chairman.

I find the discussion on estimating, Dr. Penner, fascinating. It is almost like I was back in freshman economics. It makes about as much sense now as it did then. I do not mean that critically but clearly this is an imprecise science. Neither the President, nor CBO, nor Congress can always be accurate about economic projection.

You know, we put a $10 billion "fudge" factor, $10 billion in the Gramm-Rudman-Hollings legislation. You could run the State of New Hampshire for a millennium on $10 billion. But we put it in as a "fudge" factor, a misfactor for Gramm-Rudman-Hollings deficit targets. We were told by the then-chairman of the Budget Committee that that was close enough for Government work. And now that 1 percent is not enough. Maybe it ought to be 2 percent.

EFFECT OF MEANS-TEST FOR ENTITLEMENTS PROGRAMS

But I want to move away from the estimating discussion which really is almost abstract—interesting, but abstract—to this question: If we had the will around here to means-test every entitlement program that we have—to talk about Senator Conrad's structural change question—what kind of budget savings would that produce. If we used a reasonable means-test based on current definitions of poverty and middle class, et cetera, what would that do to your numbers?

Dr. PENNER. Well, I cannot obviously give you——

Senator DOMENICI. Mr. Chairman, could I ask for a clarification? At poverty level, 120 percent of poverty level, or what?

Senator RUDMAN. 120 percent of poverty is a good number.

Dr. PENNER. I cannot give you a very accurate answer. I can, however, give you some sense of the magnitude.

Senator RUDMAN. Just a sense. Obviously, I do not expect you to have precise figures.

FIFTEEN PERCENT OF ENTITLEMENTS MEANS-TESTED

Dr. PENNER. Right now, total entitlements are over 45 percent of total outlays. Only 15 percent of those entitlements are means tested.

Senator RUDMAN. That is right.

Dr. PENNER. Obviously, a large share of the non-means-tested entitlements—like social security, medicare, et cetera—do go to poor people. But in the case of social security, if you just drew eligibility at the poverty line—I may have to correct this for the record—but I would guess that, very roughly speaking, about 10 percent of the benefits goes to people under the poverty line. Of course I do not think you would ever want to draw a very sharp line and have such an abrupt break. But, with social security at 20 percent of the budget, or close to $200 billion, if 90 percent of it were eliminated, obviously an enormous amount of money would be saved. While I do not think anybody would propose this particular action, it does represent the magnitude of the number that one would be looking at.

Senator RUDMAN. Well, I have seen some numbers, Dr. Penner—I am not sure they are your numbers or other forecasting numbers—that indicate that if you did means-testing at 110, 120, 125 percent of poverty, and means-tested on a very slight decline—I am not talking about abruptly chopping off benefits—you could achieve some significant savings. We are now taxing social security at certain levels. We started getting realistic in that regard. If all entitlements were means-tested, agricultural subsidies, veterans' benefits, I mean the whole thing, then you would see a remarkable change in this deficit line, maybe reducing the deficit projections by one-half between now and 1992. Does that seem reasonable to you?

SMALL PART OF ENTITLEMENTS GO THE POOR

Dr. **Penner**. I think the basic point is that entitlements are almost half the budget, and that just a very small portion of those go to people because they are poor and have passed a means test.

Senator **Rudman**. Well, the point of my question is obvious. There are ways to reduce the deficit. Nobody wants to do it. We do not have to sit here for the next 3 months and listen to all sorts of abstruse, abstract arguments. We know what we could do. There is not enough political will in Congress to do it. On many occasions I have done it, done it in my first term, cast almost every miserable, rotten, lousy vote you could cast. We just could not get a majority to do it.

Thank you.

Chairman **Chiles**. Senator Simon.

Senator **Simon**. Thank you, Mr. Chairman.

AMOUNT UNEMPLOYMENT ADDS TO DEFICIT

Dr. Penner, where do we stand now on your one percent unemployment equals what in addition to the deficit?

Dr. **Penner**. If we misestimated the unemployment rate by 1 percentage point, that would cause a $22 billion change in 1987, which would grow to a $54 billion error by 1992.

Chairman **Chiles**. Either way.

Dr. **Penner**. Either way. Roughly speaking, yes. Those are approximations.

Senator **Simon**. When you say "either way," you mean?

Dr. **Penner**. I mean if we either over or underestimate the rate.

Senator **Simon**. OK. And the growth from the $22 billion to the $54 billion between now and 1992 is accounted for by what? You do not have any inflation rate growth.

Dr. **Penner**. No; that number grows through time, in part, because of the growth of the number of people eligible for various things that are sensitive to unemployment. But I think an arithmetically more important point exists—that is, when the deficit is cut permanently in any way whatsoever, the Treasury can issue less debt and, therefore, start to save on the interest bill. And that accumulates very, very rapidly.

Very obviously, if the deficit is reduced by $1 for 5 years in a row, by the end of the 5 years there is $5 less debt. At a 5-percent interest rate, that is 25 cents you save there by cutting another dollar. So that really does accumulate very quickly.

REAL INTEREST RATES

Senator **Simon**. I follow you. Now, on interest rates, you make an assumption, if I follow correctly——

Dr. **Penner**. Let me perhaps correct one thing I did not take note of, namely, that the first year is particularly low relative to the others because it is only a part-year effect.

Senator **Simon**. Right. On real interest rate, the real rate of return, has been 4.4 percent in 1986; is that correct?

Dr. **Penner**. The real rate of return?

Senator **Simon**. Yes.

Dr. **Penner**. Let us see. Yes, it is roughly that.

Senator SIMON. I am using the 3-month Treasury bills as a basis there.

Dr. PENNER. And the implicit GNP deflator, that would make it about 4.0 percent for 1986, yes.

Senator SIMON. But for 1987, you would drop that real rate of return, according to your estimates, right?

Dr. PENNER. Yes; and that is, in part, because we think that there is a relationship between the deficit and real interest rates. And in our estimates, the deficit is coming down.

Senator SIMON. And so that differential is caused by an assumption that we are going to move on the deficit?

Dr. PENNER. The 1987 number is not quite in the bank yet, but part of the change in the average for the year is because of rate decreases that have already occurred.

DEFICIT ESTIMATE REQUIRES BIG CUT IN DEFENSE

Senator SIMON. All right. Then, finally, assuming the budget deficit figures that you are talking about, and assuming that we have a sequester under Gramm-Rudman that I voted for, very roughly what kind of defense cutback are we talking about?

Dr. PENNER. I am sorry, sir. If you accept our numbers, you mean right now?

Senator SIMON. Accept your numbers.

Dr. PENNER. And no changes whatsoever?

Senator SIMON. And assume we do not make any change.

Dr. PENNER. The defense change is a 14-percent cut across the board.

Senator DOMENICI. In budget authority or outlays? Which one?

Dr. PENNER. No, that is budgetary resources, defined as future defense budget authority plus obligated balances from past years.

Chairman CHILES. Can you give us a dollar number on that?

Dr. PENNER. I guess I do not have that dollar number handy.

Senator SIMON. But in response to Senator Domenici's question, you said that is budget authority and not outlays.

Dr. PENNER. Yes; that would bring budget authority down to about $250 billion after sequestration.

Senator SIMON. But the 14 percent, in fact, is dropped in outlays, right?

Dr. PENNER. No, sir. Budget resources. That would be the cut in budget resources required to get the requisite change.

Senator SIMON. All right. I thank you very much, Dr. Penner.

Chairman CHILES. Senator Danforth.

FREEZING DEFENSE WON'T DO IT

Senator DANFORTH. Mr. Penner, your estimate that to meet Gramm-Rudman-Hollings targets for 1988 we will have to reduce baseline spending by $61 billion assumes that defense spending will be frozen in real terms?

Dr. PENNER. Yes, sir. That is compared with what CBO defines as a baseline, which is a constant real level of defense spending.

Senator DANFORTH. All right. So in other words, if we freeze defense spending, assuming we freeze defense spending, we would still have to come up with $61 billion to get to Gramm-Rudman-Hollings?

Dr. PENNER. In real terms. It allows for an inflation adjustment.

Senator DANFORTH. I understand that.

CAN TARGET BE MET WITHOUT TAXES

Now, I want you to give me your advice. It may be valedictory advice given. Tell me this, Mr. Penner: Assuming that we freeze national defense, assuming we pay interest on the national debt, which we have to pay, and assuming there will be no changes in social security—and I do not hear anybody other than Senator Rudman clamoring for any changes there. And I do not think he is going to clamor very long. But assuming no changes in social security, in your judgment is it possible to reach the Gramm-Rudman-Hollings target as a matter of just being realistic? I mean, I am sure anything is possible, but just realistically, politically possible, is it possible to meet that target without increasing taxes?

UNTOUCHABLES TAKE 62 PERCENT OF BUDGET

Dr. PENNER. You have made several assumptions. You have frozen defense, which is, let us say, 28 percent of the budget. You have frozen social security, which, crudely speaking, is about 20 percent of the budget. You, of course, have to pay the interest on the debt, which is roughly 14 percent of the budget. So we are now up to 62 percent of the budget that you will not let me touch in this exercise. So, you have over $600 billion that is untouchable. On the spending side, you have a little over $400 billion left. So if you want to cut $61 billion from that, you probably do not need my advice. [Laughter.]

SALE OF GOVERNMENT ASSETS

Senator DANFORTH. Well, Mr. Penner, there is something else we can do. We can sell assets. We can see loan portfolios, real estate.

Senator RUDMAN. The Capitol.

Senator DANFORTH. That is right. I mean, we could have lease-backs for the Capitol building. I mean, think of the visitations we could have for Morgan-Stanley and Goldman-Sachs and so on on those.

Just as part of your valedictory address, do you think asset sales are a fruitful course for us to pursue in trying to reach Gramm-Rudman-Hollings targets?

Dr. PENNER. From the point of view of policy, I think each individual asset sale has to be judged on its own merits. In some cases, I think there is a broad consensus for example, Conrail, in whose sale you played a crucial role. I do not think there was much support for keeping Government in that business. There are different ways to sell assets, albeit, but other cases are more controversial. I think the same can be said for both physical asset sales like ConRail and financial asset sales like loans.

ASSET SALES NOT DEFICIT REDUCERS

I think the problem with such sales is not whether they are good or bad policy, but rather that we do not account for them currectly in the budget. I think an ideal budget document would not consider asset sales as deficit reducers—at least, that part that does not involve a subsidy—but rather would consider them as means of financing the deficit. Obviously selling an export-import loan to the credit markets is very little different from selling a Treasury debt instrument in terms of its economic effects and so on.

Senator **DANFORTH**. Would you explain that, why it does not do the job? What would you say if you were asked on national TV why asset sales just are not adequate in dealing with the budget deficit? How would you answer?

Dr. **PENNER**. Basically, there are two points to make: 1, they, in essence, absorb savings—that is, the people buying the asset generally have to go out and borrow to finance the purchase. So it does not accomplish the main goal which we are trying to accomplish with deficit reduction, which is to reduce the pressures and demands on credit markets.

The second point is that asset sales are a one-shot deal. You can only sell them once. And after they are sold, very often—not always, but very often—you have also lost a stream of revenue from that asset.

Again, I want to emphasize that neither of these points means that it is a bad idea. It may be a wonderful idea to sell them. It just is not a long run solution to the problem caused by the deficit, which is a draw on national savings.

Senator **DANFORTH**. Mr. Chairman, could I just, with your permission, re-ask the first question? Mr. Penner, you did a very adroit job of giving me your view without specifically answering it. Could you just clarify? Give me a quotable quote as to whether it is possible, in your view, to reach Gramm-Rudman-Hollings targets without a tax increase?

TOUGH TO REACH TARGET CONSIDERING UNTOUCHABLES

Dr. **PENNER**. I think, as I said that you have handcuffed me. You have frozen most of the expenditure sides of the budget.

Senator **DANFORTH**. Those are frozen. Let us assume they are frozen.

Dr. **PENNER**. So if you make that assumption, it almost follows automatically, having frozen that amount——

Senator **DANFORTH**. Interest on the debt is frozen, defense is—I do not think we are going to be cutting it; maybe we will. The President wants a 3-percent real increase. Social Security is off limits. I do not think there is any doubt about that.

Dr. **PENNER**. I hasten to add, those are all your judgments and freezes; they are not mine.

Senator **DANFORTH**. Yes; but assuming that, I hear you saying that, making those three assumptions, it is not possible to reach Gramm-Rudman-Hollings.

Dr. **PENNER**. As a technician, I cannot say it is impossible, but what we are talking about is a $61 billion cut in a $400 billion base, which means a very large change in a lot of programs. And I have not even, in that calculation, taken account of the fact that there are parts of that $400 billion cannot be cut because they are tied by previous contracts and other obligations.

Senator **Danforth**. Thank you.

CAN ECONOMY STAND TARGET WITHOUT TAX INCREASE

Senator **Lautenberg** [presiding]. Dr. Penner, just very quickly, pursuing Senator Danforth's line, is it possible without a tax increase to meet these targets without very severe economic disruption in our country?

Dr. **Penner**. I would like to answer that in two parts, sir. Quoting your literally, you said is it possible without tax increases——

Senator **Lautenberg**. The $40 billion.

Dr. **Penner**. Yes; but what about the situation if you have an increase. Let me rephrase that; maybe it is not the question you are asking. I am often asked if a $61 billion cut in the deficit would be too big a shock to the economy given the economic situation. I think the answer to that depends crucially on how you do it.

If you look at last year's budget when the Congress cut $32 billion from the deficit, about three-quarters of that amount was the result of temporary, one-time factors which have no permanent, lasting effect on either the budget or on the economy.

Senator **Lautenberg**. If they are not available the next time around.

Dr. **Penner**. They are not, but there are a lot of other temporary things you could do. If you were to apply the same proportion—say only a quarter to one-third of the $61 billion cut—to long-lasting reductions, I think my answer and the answer of most economists would be. "No problem." The economy could easily sustain this level of budget reduction.

As you start to increase the real long-lasting cut, you must begin to think about its effects. You must start to worry about the things that Keynesian economists tell us about. CBO's own forecast is based on the following assumptions: one, the target of the Balanced Budget Act is met with a $10 billion margin of error thrown in—that is to say, you reach $118 billion and about $10 billion of that cut stems from various temporary kinds of measures like asset sales. Second a real, long-lasting cut of a little over $40 billion will be made. Our forecast is consistent with that. We admittedly made the same change arbitrarily on the spending and the tax sides, of the budget. So the result depends how you like our forecast. We think that is consistent.

Senator **Lautenberg**. I am going to have to stop now, I am sorry to say, because of the vote. I do not want to adjourn the hearing because the chairman is on his way back, so if you will, I will just recess for 5 minutes.

Dr. **Penner**. OK.

[Short recess.]

Chairman **Chiles**. Dr. Penner, we are going to move the charts over here where they get a little bit out of the way. The press has complained that they are not able to see Senator Domenici and myself, and they want to be able to watch us, so we will give them that opportunity. Now they will ask me to move them back, probably.

CBO ESTIMATES PRESIDENT'S BUDGET MISSES TARGET

Can we go back to our first chart because I want to ask you some questions on it.

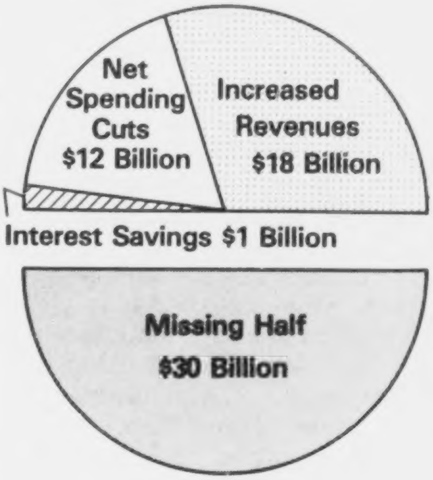
Dr. Penner, this chart portrays what I think is the CBO estimate, showing what our baseline is and setting that against the President's budget. As I understand, you are saying that the President's budget is about $30 billion short in meeting the Gramm-Rudman-Hollings deficit target of $108 billion for 1988, and that the President's plan provides for only about one-half of the required deficit reduction of $61 billion. That $31 billion is apparently the difference in assumptions.

CBO Data Shows President's Budget Misses Deficit Target By $30 Billion

Half of $61 Billion In Needed Savings Are Missing

CBO DEFICIT ESTIMATE:		
Baseline		$169
G-R-H Target		108
Needed Savings		61
PRESIDENT'S PLAN:		
Net Spending Cuts		$ 12
Defense	+ 9	
Nondefense	−21	
Revenue Increases		18
Interest Savings		1
Total Savings		$ 31
PRESIDENT MISSED TARGET BY $30 Billion		

Proposed Savings



Senate Budget Committee staff estimates based on CBO data. January 27, 1987.

Chairman Chiles. Of the $31 billion in savings provided for in the President's budget—and I want you to tell me if I have any of these numbers wrong, or if they do not agree with your numbers—about 60 percent, or $18 billion, is proposed from revenue increases. The balance of the savings or $12 billion comes from net spending cuts. Some non-defense programs would be cut by $21 billion, but those cuts would be partially offset by $9 billion in increased defense spending. My understanding is about $20 billion of the proposed savings in revenue, or $20 billion of the $30 billion, have already been rejected by Congress, and another large share will be one-time-only asset sales which will not contribute toward reducing the structural deficit.

That total leaves us about $30 billion short. Is that what your estimates are showing us?

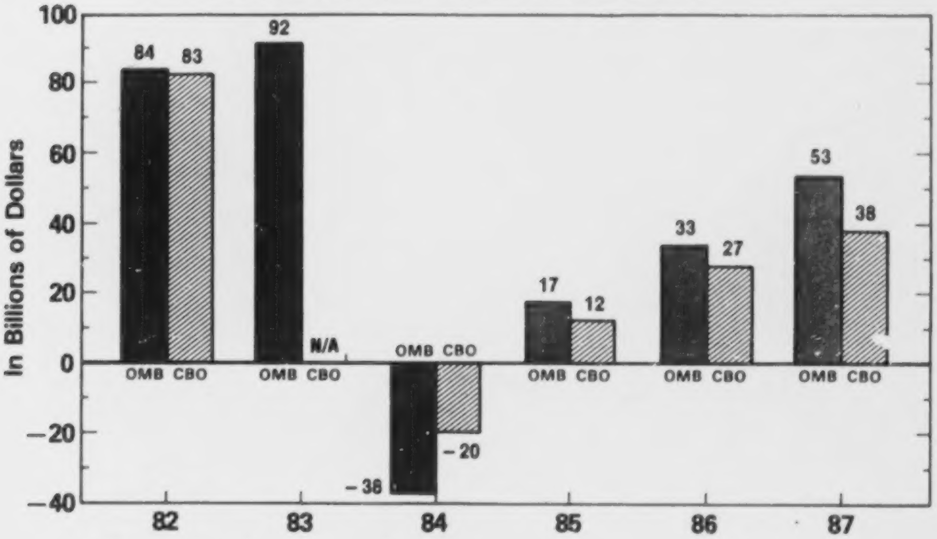
Dr. PENNER. Our basic estimates, yes. You have cited them correctly, sir. I should again emphasize, as you well know, that they have to be preliminary at this time. We have to give quite a range of estimates on them because we just today received all of the program details of the budget. Some of these differences may evaporate because of enunciated policy changes that we are not now aware of; others could increase. Within the next 3 weeks, CBO will analyze the President's budget very carefully and probably change many of these numbers to some degree. But in terms of the big picture, yes, sir, that is the way it looks.

HISTORY OF CBO/OMB MIS-ESTIMATES

Chairman CHILES. All right. I want to ask you if we can change that chart now. We talked about the mis-estimates of baseline deficits. This chart purports to show a little bit of history on that. It basically shows that in the years 1982, 1983, 1985, 1986 and 1987, both OMB and CBO were overly optimistic in the February baseline versus the actual deficit. You both missed by $83 and $84 billion respectively in 1982. Then, in 1983, the miss was more on the OMB side. Both of you were under-optimistic in the recovery of 1984, with CBO missing it by $20 billion and OMB by $38 billion. Then you went back to being overly optimistic in 1985, again, a closer period, $17 billion and $12 billion in 1986, $37 billion and $27 billion, and then back to 1987 with $53 billion and $38 billion. So basically, both have erred on being too optimistic; is that correct?

Misestimates of Deficits

February Baseline Versus Actual Deficit*



* Changes in estimates of baseline deficits due to changes in economic and technical assumptions

Prepared by Senate Budget Committee Staff, January 27, 1987

Dr. PENNER. That is right. In the 1980's that observation is certainly true. If you went back to the late 1970's, it would be a less obviously biased picture.

Chairman CHILES. You have tried to tell us before where you think some of this comes about and why this is not an exact science. But it shows us that if we take the 1980's as precedent, we cannot be too happy that for some reason you are going to be under-estimating the deficit now, based on that history.

Dr. PENNER. No, but you cannot rule it out either, sir.

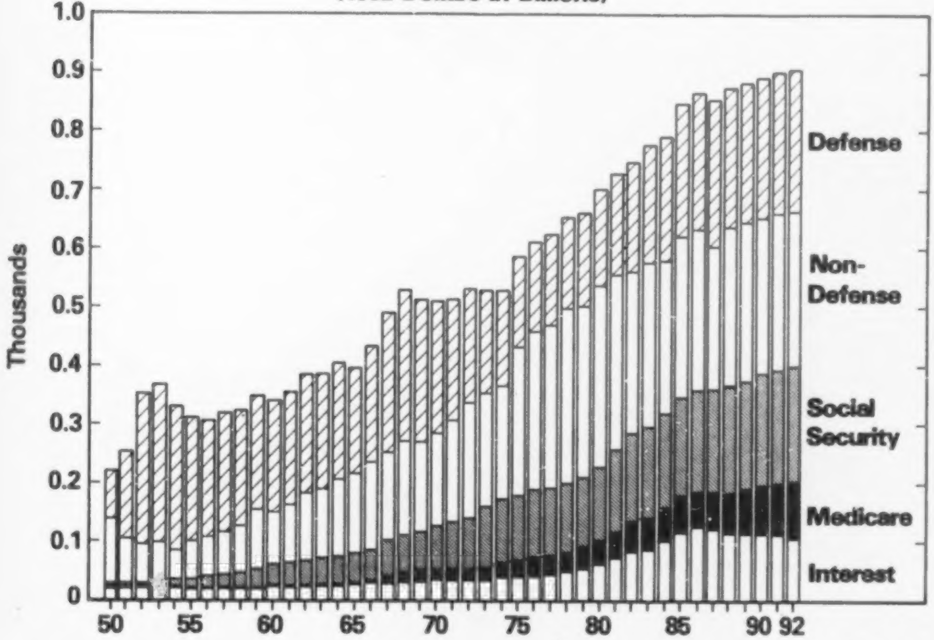
Chairman CHILES. Yes, sir. All right.

DEFENSE/NON-DEFENSE GROWTH PARALLEL

Then I would like to ask you program outlay growth. Secretary Weinberger was here a few weeks ago with a chart purporting to demonstrate that defense spending had not grown at all in real terms since 1950, while nondefense spending had exploded. This chart tries to portray basically not just defense and nondefense, but breaks out how we really speak of nondefense discretionary being the basic government programs, taking out Social Security and Medicare and interest on the national debt.

Program Outlay Growth

(1982 Dollars in Billions)



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Chairman CHILES. When we take out those charts, we see that we have parallel growth between defense and nondefense, that nondefense including a number of entitlement programs, all of the food stamp, nutrition programs, all of those, but excluding Social Security and Medicare and that interest which we see is a high figure.

Does that chart basically comply with what you would say the numbers have been?

Dr. PENNER. As far as I know, sir. I have no reason to question that.

Chairman CHILES. Well, we see that defense spending has increased about 50 percent in real terms in the 1980's, and comparison to earlier years is just as striking. Defense spending is at its highest peacetime level since World War II, and I think that puts it just a little bit more into perspective.

Is it your feeling that with the defense increase the President has proposed in his budget, that will reduce the net savings he has proposed in his cuts?

Dr. PENNER. You mean he has proposed some increase in defense?

Chairman CHILES. Yes.

Dr. PENNER. Yes; that is offset by nondefense cuts.

Chairman CHILES. And what would that offset be, according to what your calculation is now?

Dr. PENNER. I think it is about—didn't you have $9 billion on your previous chart?

Chairman CHILES. Yes.

Dr. PENNER. Yes; $7, $8, $9 billion, in that area.

Chairman CHILES. In your new annual report, you indicate about $25 billion in deficit reduction were one-time-only savings. Since your prediction of the deficit for 1987 is currently about $175 billion, doesn't that mean with the absence of these gimmicks and special one-time factors, the deficit for 1987 would be about $200 billion?

Dr. PENNER. That is right; yes, sir.

ONE-TIME SAVERS AND GIMMICK TRIM DEFICIT

Chairman CHILES. The 1986 deficit was a record $220 billion. And faced with this huge and ongoing deficit, isn't it true that we legislated only about $6 billion in deficit reduction in the 1987 budget cycle?

Dr. PENNER. Yes, sir—in the longer run.

Chairman CHILES. And your baseline figure of $169 billion now includes both Social Security revenues and outlays. The official, on-budget deficit figures must exclude Social Security, which is now legally off-budget, but Social Security is running even larger surpluses each year, and by 1992 that surplus will be about $75 billion, and it keeps on growing from there.

Isn't it true that according to CBO estimates, the on-budget baseline deficit would be about $200 billion each year through 1990 and only down to about $160 billion in 1992?

Dr. PENNER. That is right, sir, although as I suggested before in answering Senator Conrad, though social security is officially off-budget, I really do think you have to count it to get some notion of what the government is doing to capital markets.

CBO CITES CAUSE OF LARGE DEFICITS

Chairman CHILES. In your 1984 baseline report you wrote that, "These large deficits come from combining the outlay levels of the

Eighties with the revenue levels of the Sixties and Seventies." Would it be safe for me to assume that you still subscribe to those earlier words?

Dr. **Penner**. I think that one of the more impressive constants in history is that the tax burden has drifted upward slightly, but only very slightly. If you look at our historical charts—say, page 158 of our annual report—you can see that the revenue side as a percent of GNP has really been remarkably constant. It has been in the high 17 percent to 18 percent range in many years. In unusual circumstances—like the Vietnam war or at the end of the 1970's, when inflation pushed people into higher tax brackets, revenues reached 20 percent of GNP, but that level dropped again.

Looking at it the other way, if we had left things as they were in 1981, we probably would have gone down to about 17 percent of GNP, lower than the historical average, but we had TEFRA and DEFRA and the gas tax and payroll taxes and those things that brought it back up again. You will note from the CBO projections of the future, however, that, partly because of bracket creep, we do show the ratio increasing into the high 19 percent range by the end of the decade.

Chairman **Chiles**. Thank you very much, Dr. Penner. We appreciate your appearance today. We are grateful for your testimony, and we will be seeing some more of you during the cycle. Thank you very much.

We will recess our hearings now until the call of the Chair.

[Whereupon, at 3:18 p.m., the committee was adjourned.]

ECONOMICS

TUESDAY, FEBRUARY 24, 1987

U.S. Senate,
Committee on the Budget,
Washington, DC.

The committee met, pursuant to notice, at 10:10 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Lawton Chiles (chairman of the committee) presiding.

Present: Senators Chiles, Sasser, Exon, Lautenberg, Simon, Wirth, Conrad, Dodd, Domenici, Grassley, Kasten, Danforth, Nickles, and Rudman.

Staff present: Richard N. Brandon, staff director; and John Hilley, assistant director, macro-economics, trade and finance.

For the minority: G. William Hoagland, staff director; and Gail Fosler, deputy staff director and chief economist.

OPENING STATEMENT OF CHAIRMAN CHILES

Chairman **Chiles**. Good morning, Chairman Volcker. We are glad to have you with us.

For the last several years you have been a voice of reason and determination at the Federal Reserve. You have been very candid about our problems and very thoughtful about our future. We hope you will be just as open with us this morning as we get down to the bedrock of the Federal budget.

You have just returned from the Group of Seven meeting in Paris and the issues there were large. You focused on the strength of the American dollar, and the role the world's major trading partners must play in fostering a fresh means of international trade and exchange.

The United States received a pledge from the leaders of West Germany and Japan to take the steps necessary to boost their economies and to stabilize exchange rates. In return, my understanding is we made a pledge to actually reduce the Federal deficit.

Now that you have returned from the land of promises, this is the land of hard choices. Here in the Budget Committee we begin the effort to try to keep the American part of the bargain.

You have said often in the past that currency agreements are only effective if we are able to back them up with coordinated monetary and fiscal policy. And, of course, that is the hard part.

To correct the international imbalance, we have to reduce our borrowing needs. We cannot do that with a budget that relies on shadows like asset sales for deficit reduction. We are playing to a skeptical world audience and they are going to watch carefully to see what we are doing. If we hedge, they will know it. But if we do what we have promised, I think we will have the leverage to try to force them to do what they promised.

So, let's put aside all the nonsense about asset sales. It is sort of like printing counterfeit money. You only get away with it for so long before it catches up with you. I think we have to be bold, and as I see it we have to proceed along these basic lines.

We have got to get our deficit down below the President's level of $135 billion. With the deficit currently at about 4 percent of GNP, we have to reduce it at least $36 billion, or roughly 1 percent each year.

FOUR-YEAR PACKAGE SOUGHT

But the keystone is this: Everything we do must be tied together in a package. You bind the spending cuts to revenues so that the revenues are earmarked strictly for deficit reduction. You lock it all in. I would like to see us try to make it a 4-year program wrapped up and enacted into law in a single package.

It seems that we have passed the point of good intentions. We cannot promise our way into prosperity. We have got to create that prosperity and hold on to it by asserting our economic power, that ability to deliver a standard of living on a sustainable basis.

That job involves a lot of initiatives from investment in science, research, and education to a more vigorous trade policy and the development of the modern workplace. Much of it depends on our ability to cut the deficit, and we have to face up to where we are and what we have got to do. And so we know that you will always give us the facts, straight and unvarnished, and we look forward to that.

There are certain things that I want to hear from you. I have talked about what I saw as a deficit reduction package. I would like to know your version of a deficit reduction package. I would like to know what gives more flexibility on the monetary side; a 1 year reduction in the deficit through asset sales, or a multi-year reduction in the structural deficit through a reconciled spending and revenue package.

In other words, to make the Group of Seven agreement succeed, would we not be better off with a package of spending cuts and real revenue increases, rather than turning to loan asset sales? Senator Domenici.

OPENING STATEMENT OF SENATOR DOMENICI

Senator Domenici. Thank you very much, Mr. Chairman.

Chairman Volcker, it is good to have you here at a time when there are so many other domestic and international concerns and demands for your time and your attention. Last Thursday before the Senate Banking Committee you stated that you rarely lose sleep because of worries that we here in Congress will cut the budget deficit too much or too quickly.

Well, I might say with you, Mr. Chairman, that I agree that I lose sleep, but certainly not over that, either. Quite to the contrary, today it is a lack of deficit reduction that is the cause of concern, not that we are going to reduce the deficit too much.

STRANGE COINCIDENCE

I would like to hear your views on the current economic problems, including your views on why it is important to reduce the deficit. These problems would surely make even Rip Van Winkle have insomnia. Using the CBO forecast of GNP for 1988 and a little arithmetic, I arrive at a value for the 1988 deficit of $108 billion.

I assume the similarity of the numbers to the Gramm-Rudman-Hollings is not just a coincidence, because as I understand it, one of the outcomes of the Group of Five that met in Paris this weekend was that the United States agreed to reduce the Federal budget deficit in 1988 to 2.3 percent of GNP.

I read that somewhere. I assume that is the case. What I am saying is that by a strange coincidence, that is the Gramm-Rudman-Hollings $108 billion deficit.

Chairman Volcker, you and Treasury Secretary Baker were our representatives at that meeting so I presume that you endorse efforts to meet the target of $108 billion in 1988. I, too, hope that we are able to meet that deficit reduction goal, the one that you are presumed to have agreed upon with our industrial friends, as you asked them to increase and stimulate their economies.

TRADE OLD PROGRAMS

I see many new legislative initiatives that are likely to add to the expenditure side of government. I support some of them, but I also support trading out some old programs to pay for them. Increased spending to bail out the Farm Credit System may reach nearly $8 billion, from what we understand.

Our Nation's Governors estimate that welfare reform may increase spending by another $2 billion. It is not clear whether that is one billion from us and one from them, but nonetheless, they are talking about two.

We hear about new education initiatives. Albeit, they are targeted in the science and technology areas, they are new initiatives.

Another reason that the deficit reduction will be difficult to achieve depends in part upon the actions that you at the Federal Reserve take with respect to monetary policy. I do not think anybody denies that and I think you know that.

SLOWER MONETARY GROWTH RATES

It does concern me that your report from last week projects a slight slowing in the growth of monetary aggregates in 1987. A rise in interest rates this year would increase the cost of debt service, reduce revenues, and increase spending.

You at the Federal Reserve are—and you know this—a partner in determining the size of the budget deficit and you must also do your part to bring it down. And certainly the chairman is correct, you are a voice of reason and you have been extremely accommodating, considering the difficult nature of things in today's world marketplace.

Short term real interest rates are still extremely high by historical standards, even after the substantial decline in nominal rates last year. It is my opinion that a rise in interest rates now would be a change in the wrong direction. The economy is not performing in all of its sectors as well as we would like, and I believe for interest rates to go up would kill that growth and minimize the chance of sustaining the recovery.

It would add to the burden of that sector of the economy that is having the most difficulties; all of the commodities, including agriculture, which are desperately hurt today.

MONETARY POLICY BEING HELD HOSTAGE

Reducing the Federal Government's borrowing demand certainly is necessary to reduce real interest rates. But I am concerned that there are several other factors at work here that keep interest rates high, whatever the deficit. Deregulation of the financial markets has led to higher interest rates. Continued fear of inflation may do this as well. The most disturbing information to me is that our debt to foreign countries is getting so large that our monetary policy is being held hostage by the need to maintain foreign confidence.

Chairman Volcker, there is no one that I would place more trust in as far as monetary policies than you, and I think you know that. But I do hope that monetary policy is not held hostage to the situations that I have described and that you do everything possible, within your power, to not let interest rates go up and hopefully we will do our share, and today maybe we will hear from you what we have to do in order to make that job on your part easier.

Thank you very much.

Chairman CHILES. Thank you. Mr. Chairman we would be delighted to hear from you now.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Thank you, Mr. Chairman. I have submitted a statement, as you know, of some length and some similarities to one I gave last week.

Chairman CHILES. It will be included in its entirety in our record.[1]

Mr. VOLCKER. Good. I will just read, perhaps, a little part of it that I think makes the central point. I do think, as a preliminary, that we at one and the same time are in a very promising economic situation. After 4 years of expansion there are possibilities for extending that expansion for a long time further and some of the traditional signs of trouble, like rising interest rates and rising inflation rates, have been absent to date.

But nonetheless, I do not think that absence of some of the traditional cyclical problems we have had in the economy should delude us, because it is evident that the economy is struggling with very serious structural distortions and imbalances that for us in the United States have little precedent.

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[1] See p. 237.

PERSONAL SAVINGS RATE LOW

Economic activity over the past 2 years has been supported very largely by consumption. That has been at the expense of reduced personal savings rates that by world standards were already chronically low. At the same time, as you know, the huge Federal deficit is absorbing a disproportionate amount of our limited savings. Now it's true that for a time we had largely escaped the adverse consequences for financial markets of that insidious combination of low savings rates and high Federal deficits by drawing on capital from abroad.

The dramatic point is that the flow of that capital from abroad in 1986 actually exceeded all the savings by U.S. households. The other side of that coin, however—the other side of the capital inflow—is a massive trade and current account deficits. And that restrains growth in manufacturing generally and it dilutes incentives for the industrial investment that we will need in the years ahead.

The simple facts are that we are spending more than we produce and that we are unable to finance at home both our investment needs and the Federal deficit. Those are not conditions that are sustainable for long, not when, as at present, the influx of capital from abroad cannot be traced to a surge in productive investment.

I do not think it is sustainable from an economic perspective to pile up foreign debts while failing to make the investment that we need, both to generate growth and to earn the money to service the debts. As you gentlemen know, it is not supportable politically as the pressures on our industrial base are transmited into demands for protection.

And ultimately it is not going to be supportable from an international perspective either as the confidence that underlies that flow of foreign savings will be eroded. Sooner or later that process will stop; the only question is how.

NO SIMPLE, SINGLE APPROACH

Now, what I argue, of course, very strongly, and I think in line with the discussions in Paris over the weekend, is that there is no simple, single approach. We have to rely upon a combination of policy instruments. There are responsibilities here, and there are responsibilities by other countries.

I think it is inevitable, too, that results are going to take time, but the results will come with greater certainty. And they should be consistent with maintaining growth here and abroad with progress toward underlying price stability and with open markets, if we take a broad-based package approach.

I think that is the course upon which we collectively are embarked, and, of course, the course that was endorsed last weekend. This process is going to require an unusual combination of discipline, patience, and international cooperation, but I don't think there is any real choice.

Now let me emphasize, too, that important steps have been taken in the needed directions. Most obviously, the value of the dollar vis-a-vis the currencies of other industrialized countries has declined substantially, placing our industry in a much stronger competitive position.

The deterioration in the trade deficit overall appears to have been stemmed, even if clear evidence of the reversal is still lacking. I think we have to recognize that depreciation of the dollar carries in its train rising import prices, but we have been fortunate that the initial impact on the overall price level was more than offset by falling oil and other commodity prices.

Meanwhile, we have been fortunate that the flow of capital from abroad has been well maintained as the dollar depreciated. Nevertheless, as we succeed in reducing our current account deficit, the net capital inflow will decline as well. It is that fact that emphasizes the critical importance of one of the policy assumptions that you have referred to in the weekend statement—that the United States must move ahead with further reductions in our Federal budget deficit, the deficit that absorbs so much of our own savings.

I think the progress that's being made this year is heartening, but it can only be a start. The projected reduction of $40 to $50 billion this year is from a record high deficit of more than $220 billion in fiscal 1986, which was more than 5 percent of the GNP. And that reduction, as you are well aware, is being assisted by some temporary factors. Progress next year will be harder.

REINFLATING ECONOMY WILL NOT SOLVE PROBLEM

Success in my mind will require a reasonably steady downward pace in the deficit as the economy grows. And that progress will need to be maintained by measures that can be sustained year after year. Failing that, it's hard to see how a sustained decline in the trade deficit, if possible at all in the face of huge budget deficits, will bring net benefit to the economy. The clear implication of failure would be congested capital markets, higher interest rates, strong inflationary dangers, and threats to growth.

I think that is the heart of my message to the committee, Mr. Chairman. I think there is a need for complementary action by other countries, as you have suggested. There are implications in all of this for monetary policy and in that connection I must emphasize that I do not think we can solve the problem by reinflating the economy.

We went through that process of inflation for more than a decade. It rather got a hold of us and accumulated. We dealt with that only with great effort and some of the scars are still present. I think it would be a serious mistake to acquiesce in a resurgence of the inflationary process. Monetary policy has to be conducted with a view toward that danger as well as sustaining growth.

It gives us less flexibility than we would otherwise have, and, of course, the higher the budget deficit is, the more problems we have in dealing with the inflationary threat while sustaining growth and maintaining interest rates at as satisfactory level. So the two problems are certainly here and your responsibilities and our responsibilities.

Chairman CHILES. Thank you very much.

[The prepared statement of Chairman Volcker follows:]

Testimony by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

United States Senate

February 24, 1987

I appreciate this opportunity to appear before this Committee today. As you know, the Federal Reserve submitted its semi-annual monetary policy report to the Congress last week. That report, which we have distributed to you, describes in detail our plans for monetary policy, including the Federal Open Market Committee's ranges for growth of money and credit. My prepared remarks this morning will be confined to more general considerations of domestic and international economic policies within the context of recent and prospective developments.

The Economic Setting

The current economic expansion -- now extending into its fifth year -- is already among the longest in peacetime history. It is unusual in other respects as well, including the absence of certain signs of cyclical excesses that often develop after years of expansion. For instance, inventories have been held well within past relationships to sales, and spending by manufacturers for plant and equipment has, if anything, been restrained relative to prospective needs.

While the overall rate of economic growth has been rather moderate since mid-1984, averaging about 2-1/2 percent a year, that growth has been maintained despite strong pressures on sizable sectors of the economy. Oil exploration and development activity and agricultural prices have both been heavily affected by worldwide surpluses. Commercial construction in many areas is suffering from earlier over-building. Regions of the country in which those impacts have been particularly large have thus remained relatively depressed. Difficult as those regional conditions have been, however, many of the necessary adjustments are well advanced and other areas of the economy have been moving strongly ahead.

More importantly, both the inflation rate and interest rates, after four years of expansion, are substantially lower than when the recovery started. Homebuilding is being well maintained, and both capital and labor appear available to support further growth for some time without undue strain on resources. Certainly, conditions in financial markets, with stock prices exuberant and interest rates generally as low as at any time since the mid-1970s, appear supportive of new investment.

But if the traditional indicators of cyclical problems are largely absent, it is also evident that the economy is struggling with structural distortions and imbalances that, for us, have little precedent. Economic activity over the past two years has been supported very largely by consumption. That has been at the expense of reduced personal saving rates that, by world standards, were already chronically low. At the same time, the huge federal deficit is absorbing a disproportionate amount of our limited savings.

For a time, we have largely escaped the adverse consequences for financial markets of that insidious combination of low saving rates and high federal deficits by drawing on capital from abroad -- the flow of which in 1986 actually exceeded all the savings by U.S. households. The other side of that coin, however, is a massive trade and current account deficit, restraining growth in manufacturing generally and incentives for the industrial investment that we will need in the years ahead.

The simple facts are that we are spending more than we produce and that we are unable to finance at home both our investment needs and the federal deficit. Those are not conditions that are sustainable for long -- not when, as at present, the influx of capital from abroad cannot be traced to a surge in productive investment.

It's not sustainable from an economic perspective to pile up foreign debts while failing to make the investment that we need both to generate growth and to earn the money to service the debts.

It is not supportable politically, as the pressures on our industrial base are transmuted into demands for protection.

Ultimately it will not be supportable from an international perspective either, as the confidence that underlies the flow of foreign savings will be eroded.

Sooner or later, the process will stop. The only question is

The Broad Policy Approach

In concept, we could shut off the flow of imports by aggressive, broadbrush protectionist measures. But the result would be to drive up the rate of inflation and interest rates here, to damage growth abroad, and to invite retaliation. Instead of sustained and orderly growth, we would invite world-wide recession.

We could try to drive the dollar much lower -- or complacently sit back while the market forces produce that result. But that too would undermine the hard-won gains against inflation, and would risk dissipating the flow of foreign capital we, for the time being, need. The stability of financial markets would be jeopardized, and export prospects could be undercut by adverse effects on growth abroad.

Both of those courses were specifically rejected by the Finance Ministers and Central Bank Governors at their meeting in Paris last weekend.

Faced with similar circumstances, many smaller countries might reasonably embark upon strong austerity programs -- indeed sooner or later would be forced to undertake such programs. Large doses of fiscal and monetary restraint would be taken, risking recession in the short run, but also anticipating that exports would respond vigorously, imports would decline, and their economies would soon resume growth on a much sounder footing. But, in the context of a sluggish growth of the world economy, for the United States to take that course would entail particularly high risks and the results would be problematical at best.

There is a reasonable alternative. It is more complicated, but at the same time much more promising.

We can draw upon a combination of policy instruments to encourage the needed adjustments. Results may take time. But those results will come with greater certainty -- and they should be consistent with maintaining growth here and abroad, with progress toward underlying price stability, and with open markets.

That is, in fact, the course on which we collectively are embarked, and the course that was endorsed at the meetings in Paris.

To be sure, its success will require an unusual combination of discipline, patience, and international cooperation. However, given the stakes not just for the United States but for others, I don't think there is any real choice.

Important steps have already been taken in the needed directions. Most obviously, the value of the dollar vis-a-vis the currencies of other industrialized countries has declined substantially, placing our industry in a much stronger competitive position. The volume of exports is rising, despite relatively slow growth abroad. The deterioration in the trade deficit overall appears to have been stemmed, even if clear evidence of a reversal is still lacking. Moreover, while the depreciation of the dollar inevitably carries in its train rising import prices, we have been fortunate that the initial impact on the overall price level was more than offset by falling oil and other commodity prices. The underlying inflation rate, measured by trends in wages relative to productivity, has continued to fall.

Given the size of the exchange rate adjustments already made among the major countries, there is a point beyond which further instability would damage both our objectives and those of our trading partners. Against that background, the Ministers and Governors of the leading industrialized countries collectively agreed last weekend that "their currencies [are] within ranges broadly consistent with underlying economic fundamentals" on the assumption certain broad economic policies are carried out.

We have been fortunate that the flow of capital from abroad, buoyed by the rising stock and bond markets here and by some declines in interest rates abroad, was well maintained as the dollar depreciated. Nevertheless, as we succeed in reducing our current account deficit, the net capital inflow will decline as well. That emphasizes the critical importance of one of the policy assumptions referred to in the weekend statement -- that the United States move ahead with further reductions in the federal budget deficit which absorbs so much of our own savings.

The progress being made in that direction this year is heartening. But that can only be a start. The projected reduction of $40 to $50 billion this year is from a record high deficit of more than $220 billion in fiscal 1986 -- more than 5 percent of the GNP -- and it is being assisted by some temporary factors. Progress next year will be harder.

Success in my mind will require a reasonably steady downward pace in the deficit as the economy grows -- and that progress will need to be maintained by measures that can be sustained, year after year. Failing that, it's hard to see how a sustained decline in the trade deficit, if possible at all in the face of huge budget deficits, will bring net benefit to the economy. The clear implication would be congested capital markets, higher interest rates, strong inflationary dangers, and threats to growth.

International Consistency

Inevitably, because we loom so large in the world economy, marked improvement in our trade balance will be matched by noticeable deterioration elsewhere. Appropriately, that should take place largely in the major countries with exceptionally large surpluses -- notably Japan and Germany, both of which are now experiencing some decline in real net exports. That process cannot take place smoothly and effectively unless those countries and others are able to maintain a strong momentum of internal demand.

For years, those countries have been dependent for growth mainly on high and rising export surpluses. In both instances, some shift toward domestic demand was apparent in 1986, encouraged partly by some relaxation of monetary policies. That points in the needed direction. Again, the Paris statement provided an indication of the intent of Japan and Germany, along with others, to sustain growth by stimulating domestic demand if necessary.

What is critical from a world perspective is not the precise nature of these measures or their exact timing, but that, at the end of the day, those countries are successful in maintaining a strong momentum of growth even as they absorb more imports from the rest of the world.

Some newly industrialized countries also have clear responsibilities for contributing to a better world balance. Taiwan and Korea, in particular, have or are building external surpluses that are large even by the standards of the traditional industrial powers. Part of that reflects a strong competitive position, but both also maintain a strong wall of protectionist barriers. The very strength of their external positions points -- in the interests of their own citizens as consumers, as well as of world equilibrium -- to the need for more forceful action to increase imports, whether by reducing tariffs, by lifting other trade restrictions or by exchange rate changes.

Success in these efforts, I must emphasize, will not necessarily or primarily be measured by changes in our own bilateral trade vis-a-vis particular countries. An open competitive trading order is by its nature multilateral, and we and others should judge equilibrium in a world-wide context.

In that connection, most of the developing world, already carrying heavy debt burdens, is in no position to revalue currencies or to absorb much higher imports (from the United States or from others) without more or less parallel increases in their exports. In recent years, however, it has been the United States that has, in fact, absorbed the great bulk of what increase in exports Latin America has had -- their exports to Europe and Japan have apparently increased little if at all.

For us to close our markets to them now would assuredly thwart prospects for expansion, and with it the encouraging progress that has been made toward both more open, competitive economies and political democracy. What is needed instead is greater access by those countries to growing markets in Europe and Japan as well as here. The recent changes in exchange rates in the industrial world certainly provide greater incentives for exports of the developing countries to shift to Europe and Japan. At the same time, imports by the developing world from the United States have become much more price competitive than a year or two ago.

The Debt Situation

I cannot neglect emphasizing one further continuing threat to growth and financial stability involving the developing countries. Management of the debt problems of Latin America and some other developing countries is again at a critical stage. The reason is not that progress is absent. To the contrary, most of the heavily indebted countries have been growing -- if for the most part far below their potential -- debt burdens are tending to move lower relative to exports or other measures of capacity to pay, and new financing needs have been reduced. Perhaps most encouraging, there has been definite, if sometimes hesitant, progress toward liberalizing trade, opening markets, and reducing internal economic distortions, with the World Bank playing a particularly helpful role.

At the same time, any failure of the industrialized countries collectively to achieve a satisfactory rate of growth would clearly impair prospects for the developing countries to find the markets they need. More immediately, in recent months, the process of reaching agreement on adequately supportive and timely financing programs, whether by restructuring existing debts or by arranging what new loans are necessary, has conspicuously slowed.

Now, the largest of the debtor countries, Brazil, after a period of strong expansion, large trade surpluses, and greater price stability, is again experiencing pronounced inflationary pressures and economic difficulties. Its suspension of most external interest payments to private creditors underscores the urgency of coming to grips with its internal economic difficulties as well as developing an appropriate financing program. I suspect the very fact that progress has been made over the past five years -- until recently in Brazil as in a number of other countries and most evidently in reducing the exposure of banks relative to capital to something like half of what it was in 1982 -- has had the unfortunate effect of dulling a sense of urgency and cooperation in dealing with the remaining problems. I do not want to deny the progress. But to fail in carrying through on past efforts or in dealing with the new points of strain would plainly jeopardize past successes and threaten new strains on the financial system.

Implications for U.S. Policy

Several key implications of all this for the United States should be clear.

First, the process of restoring external balance requires first of all that we tend to our inescapable responsibilities to deal with our budget deficit. That is not just because we are dangerously dependent on foreign savings but because progress abroad is, as a practical matter, likely to be stymied without constructive leadership from the largest and strongest nation. Should we instead resort to closing our markets, be indifferent to depreciation of our own currency, and permit inflationary forces to regain the upper hand, then there would be no basis for confidence in the United States. Prospects for effective complementary action abroad, or for growth for the world economy, would be dim indeed.

Second, we have to recognize that the needed adjustments will require a relative shift of financial and real resources into internationally competitive industry and away from consumption and federal deficits. Without a sharp rise in overall productivity from the one percent or so rate characteristic of most of the 1970s and 1980s -- and I see no reason to suggest that trend will change abruptly -- the recent rate of increase in consumption is simply unsustainable for long. Instead, more of our growth will need to be reflected in net exports and business investment, and less savings will be available to finance government.

Fortunately, performance with respect to productivity growth and restraint on costs in the key manufacturing sectors has been relatively strong during the period of economic expansion. That reinforces prospects for a stronger competitive position internationally. The challenge will be to maintain that performance in the face of a depreciated currency, higher import prices, and more sizable needs for new investment to meet domestic and export opportunities.

Finally, achieving these goals in the context of sustained growth and reasonable price stability is beyond the capacity of any single policy instrument. Quite obviously, monetary policy will have a critical role to play. In doing so, it has the potential advantage of more flexibility than other policy instruments. But there will also be a heavy premium on maintaining discipline and sound judgment amid potentially conflicting criteria.

Monetary Policy

Looking back, monetary policy has accommodated a relatively rapid growth in the various monetary aggregates for some time; in 1986, the discount rate was reduced four times by a total of 2 percentage points, more or less in line with reductions in market interest rates.

This generous provision of reserves and expansion in money took place in, and appeared justified by, an environment of restrained economic growth and declining inflationary pressures. The latter, to be sure, was dramatically and importantly reinforced by a temporary factor -- the sudden collapse in the price of the world's most important commodity, oil. But, potentially more lasting indicators of inflationary pressure -- the rate of increase in workers' compensation and in prices of some services that respond slowly to changes in the economic environment -- were also trending downward. For much of the year, most commodity prices other than oil, measured in dollars, were falling despite the depreciation of the dollar in the exchange markets. Moreover, the sizable declines in long-term interest rates seemed to reflect some easing of fears of a resurgence of inflationary pressures in the future.

Nonetheless, the possibility of renewed inflation remains of concern both in the markets and within the Federal Reserve. One potential channel for renewed inflationary pressures would be an excessive fall of the dollar in the exchange markets.

Moreover, the continuing rapid expansion of debt throughout the economy -- running far above the rate of economic growth since 1982 -- has raised one warning flag.
The implicit dangers should be clear. More leveraging of corporations, aggressive lending to consumers already laboring under heavy debt burdens, and less equity in homes all increase the vulnerability of the economy to economic risk -- to higher interest rates, to recession, or to both. The fact that, after four years of expansion, many measures of credit quality are tending to deteriorate rather than improve, and that too many depository institutions are strained, should be warning enough.

As we look ahead, the Federal Reserve remains highly conscious of the long historical patterns that relate high rates of monetary growth over time to inflation.

In 1987, the effects of the depreciation of the dollar and the rebound in oil prices are very likely to be reflected in somewhat larger increases in consumer prices than last year. What is critical is that such a bulge in prices related to identifiable temporary external developments not be translated into a broad-based cumulative upward movement. As you well know, just such a cumulative inflationary process started in the 1960s and then extended well over a decade into the 1980s. It was eventually brought to an end, but only with great effort and at considerable cost. The scars of that experience remain.

Against that background, participants both in financial markets and in business have persistently been skeptical of prospects for lasting price stability in making investment and pricing decisions. They are bound to be alert and responsive to any sense of adverse change in the underlying inflation trend, with implications for interest rates, exchange rates, and pricing policies. The consequences for the economy would clearly be undesirable.

In effect, neither the internal nor external setting permits thinking of trading off more inflation for more growth. Nor would inflation ease the problem of international adjustment; quite to the contrary, it would both undercut some of our competitive gains and threaten the orderly inflow of funds from abroad. Naturally, in the conduct of monetary policy, we will want to encourage continuing economic expansion. But we also want to see as long an expansion as possible. To that end, the threat of renewed inflation will require continuing caution to avoid excessive increases in money and credit. Clearly, further sizable declines in the federal budget deficit will make our job in the Federal Reserve easier.

Concluding Comments

In sum, we face, at one and the same time, most difficult and most promising economic circumstances.

They are difficult because there are obvious distortions and imbalances within our economy and internationally. Unless dealt with forcibly and effectively, those imbalances will impair both growth and price stability -- and the adverse implications will be amplified by the effects on other countries. Moreover, those imbalances will not yield to any single instrument of policy, however wisely conducted. Instead, what is required is complementary actions here and abroad -- on budgets, on monetary policies, and on maintaining appropriate exchange rates and an open trading order.

I know none of that is easy. Many countries are involved, and all of them have tough political decisions to make. Nor are the key decisions entirely in the hands of governmental authorities. American industry, in particular, has the challenge to build upon the efforts of recent years toward effective control of costs and greater efficiency, and to seek out and exploit the greater market opportunities that exist today.

From one point of view, it may seem like a lot to ask. But equally, there is a lot to be gained.

We already have achieved a long economic expansion. We have managed to combine that with progress toward price stability -- and that progress has made possible lower interest rates. Financial markets more generally reflect renewed confidence. And the broad outline of policies that can preserve and extend those gains are by now well known.

To fail to act upon those policies -- to instead retreat into protectionism, to relax on inflation, to fail to deal with the deficit -- may in some ways appear to be the course of least resistance. But those are also precisely the ways by which we would turn our back to the bright promise before us.

It is only a concerted effort here and abroad that will extend and reinforce the economic expansion, consolidate the progress toward price stability, and provide the international environment in which all countries can prosper.

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Chairman **Chiles**. Senator Simon.

Senator **Simon**. Yes; thank you, Mr. Chairman.

IMPORTANCE OF BUDGET TARGET/KIND OF TAXES NEEDED

First, when you talk about a combination of policy instruments, obviously fiscal policy has to be part of this. A I look at the 2.3 percent goal that Senator Domenici talked about, and $108 billion target, that means substantial cuts in spending, and also substantial increases in revenue. The revenue increases, as I look at a possible package, have to be around $30 billion to get down to the kind of figure we are talking about.

I guess, No. 1, how important is it that we reach that $108 billion or get close to that? And second, to get to $30 billion would you have any preference as to the kind of tax that would not do harm to the economy?

Mr. **Volcker**. Well, let me make a few comments. You have objectives that have been set out in the Gramm-Rudman-Hollings legislation and I think like all institutions you have to work with some targets in mind and set yourself some objectives and see whether you can meet them.

What is economically important, obviously, is not precisely meeting an exact target of that sort, but to be convincing in terms of substantial reductions, and not just in 1988, but I think in subsequent years. So you can be as convincing as you can be that the improvement will be sustained, and that is very important, I think, for confidence, for the financial markets, for the performance of the dollar, and all the rest.

Now, when you consider those targets you have to take into account security considerations—national security, social security, other objectives of government. But from an economic standpoint, the more you can do on the spending side, the better. I think the economy will, from a gross standpoint, perform better the more you can close that gap on the spending side.

If and when you have to turn to revenues for some help, you would look for ways that—all taxes hurt—do less damage to incentives, less damage to savings. I think those that are most consistent with the efficient performance of the economy. Now, that is a very broad guideline.

ASSET SALES WON'T DO THE JOB

Senator **Simon**. OK. If I can narrow that broad guideline just a little bit here. First of all, when you say you want to see sustained effort, what you are implying—as the chairman implied in his opening remarks—is that a one-time sale of assets does not provide that kind of long-term reassurance to the financial markets. Is that correct?

Mr. **Volcker**. I think in a relative sense that is correct. Of course, the sale of assets itself must be financed in the credit market, so it does not have the same impact—either the same lasting impact or the same economic impact—as other efforts to reduce real spending or increase revenues, if it came to that. I do not think that is the only issue involved in asset sales.

TAXES NOT HARMFUL TO THE ECONOMY

Senator **Simon**. I understand. And I am not opposed to all asset sales, either. But then, if I may get more specific on revenue, in your opinion, would these alternatives be particularly harmful or would they not be harmful to the economy; postponing indexing on taxes?

Mr. **Volcker**. Well, on that particular one, if you want a response, the fact is I have never been a fan of indexing at all. So I happen to have a position on that particular issue. I do not know if it is unique or not.

Senator **Simon**. All right.

Senator **Domenici**. Would the Senator yield?

Senator **Simon**. I will be pleased to yield.

Senator **Domenici**. Are you financing on one side of the ledger and not on the other?

Mr. **Volcker**. I am not a fan of indexing on either side.

Senator **Domenici**. I thought that was right.

Senator **Simon**. All right. Well I join that trio in not being a fan of indexing. A tax on cigarettes? Notice I did not say cigars here, Mr. Chairman.

Mr. **Volcker**. Well, I am in no position to oppose taxes on cigarettes or cigars.

Senator **Simon**. All right.

Mr. **Volcker**. They have the disadvantage of going into the consumer price index, unfortunately. No tax is entirely free of problems.

MUST BALANCE OIL TAX WITH ENERGY POLICY

Senator **Simon**. All right. Oil import fee?

Mr. **Volcker**. Oil import fee. I think that really gets to a question of your energy policy. You are out of my area of expertise, obviously, but I would make one observation on an oil import fee; it has got some advantages.

On the other hand, it has always seemed to me if you are going to have an oil import fee it certainly had to be integrated with a broader energy policy, and the question arises as to whether you put an oil import fee, let's say, on imports from our neighbors in Canada and Mexico, and the question maybe arises for the western hemisphere generally. And if you begin making exemptions it is not worth much in terms of revenues.

So I think you have got to weight that very heavily with energy policy considerations rather than a purely revenue measure.

Senator **Simon**. All right. I see my time is up. Thank you, Mr. Chairman.

Chairman **Chiles**. Senator Domenici.

CAUSE OF HIGH INTEREST RATES

Senator **Domenici**. Chairman Volcker, to what do you attribute the current high level of short-term interest rates in the United States?

Mr. **Volcker**. Well, I am not sure they are particularly high.

Senator **Domenici**. Well, they are high compared to those of the people that you were negotiating with. You went to see the other industrial countries.

Mr. **Volcker**. We have higher short-term interest rates than in Germany and Japan. We have lower rates than in some other countries. Germany and Japan in particular have a remarkably favorable performance on prices. They have an appreciating currency. They had a decline in wholesale prices last year, for instance, of about 10 percent, no change in consumer prices, and I think their outlook for prices, and in fact their past record has been, unfortunately, better than ours.

Now, you get an appreciating currency, a good price record, a rather sluggish economy in both of those cases, those are all forces that tend to produce lower short-term and long-term interest rates and you see that reflected in the marketplace.

EFFECT OF RISE IN MONETARY POLICY

Senator **Domenici**. Well, Mr. Chairman, I understand that you do not necessarily—and thank God you do not—follow the recommendations of budget committees or banking committees. Perhaps you do not even follow the recommendations of the White House with reference to monetary policy. I think that is good. I think that is why we created the independence that is yours.

But I understand that Senator Proxmire, perhaps joined by some others, has begun to suggest that the Fed should tighten the monetary policy. My quick historical review of real interest rates, short-term interest rates, indicate that for the period of 1950–59 it was half of 1 percent. I will jump down to——

Mr. **Volcker**. You are talking in real terms?

Senator **Domenici**. Yes, sir. 1980–86 it was 4 percent. I will break that down specifically. In 1981 it was 4.3 percent, 1982, 4.3 percent, 1983, 4.7 percent, 1984 it shot up again to 5.7 percent, 1985 it was 4.1 percent, and 1986 it was 3.2 percent.

Mr. Chairman, while you would tell us you have nothing to do with interest rates, it is my opinion, looking at history, that if you tighten the monetary policy—that 1 year trend of going down from 4.1 percent to 3.29 percent is surely not going to continue downward—that the probabilities are that the interest rates will go up.

I want to suggest that I think that that would be devastating. I see no good coming out of it, whether it is for the energy industry in my state that is flat on its back, or for the farmers, or for the American economy and that optimistic view that you suggested in your opening remarks, that we may have a continued growth economy and that you are rather optimistic.

I think interest rates going up has more potential for causing that optimism to turn into pessimism than anything else, and I do not quite understand why we should even be considering it. We have reduced the deficit. Some do not like the method. Some think it was sloppy. Some think the continuing resolution was an abomination.

But, we reduced deficits more in 1 year than we have in any year in the history of the republic. If it holds this year from 1986 to 1987, it will be the largest reduction. Secondly, the growth of expenditures is slower in the United States now than it has been, literally, in decades—that is, the expenditure side of the ledger.

Now, why would we be concerned enough to even take a risk with higher interest rates?

INTEREST RATES NOT CONSISTENT WITH SIZE OF DEFICIT

Mr. **Volcker**. Well, I do not know particularly why you are projecting an increase in real interest rates. I am not making a projection in either direction. You cite such things as the progress made on the budget deficit, which, of course, I welcome. And you had an enormous contribution to turning that situation around.

But I have to, of course, point out that the deficit is about as high relative to the GNP—with the exception of the record last year—as it ever gets, and certainly extremely high for a period of business expansion. And after 4 years of business expansion that deficit is absorbing a very large share of our domestic savings.

So that is hardly in a position where, despite your efforts and those of others, it is consistent with as low interest rates as we have enjoyed in real terms at times in the past. And I think that just has to be recognized. I do not think we can brush away the fact that we are terribly dependent upon a flow of capital from abroad. And if we conduct our policies in a way that does not maintain confidence in the outlook in the United States—and a very important ingredient in that confidence is keeping inflation under control—we may not enjoy such a free flow of capital from abroad, which would indeed have extremely adverse effects on interest rates should that confidence be undermined.

DEFICIT TRENDING DOWN

Senator **Domenici**. I have no disagreement with that statement. I do not think that I have ever been heard to say that we have done enough on the deficit side. I merely have indicated that if you look at the trend line and we do not do anything crazy, it has been turned around. It is already heading in the right direction, not the wrong direction, as it was 2 years ago, and that the thing that would devastate that more than anything else is if the interest rates went up.

I think we would take one step forward and two backward if that occurs, and I am absolutely confident of that and I understand the reasons that you would be concerned about inflation. And I also understand we could not debt service this American deficit without the confidence of foreign countries who are investing their money, both in our T bills and in our capital economy.

Nonetheless, I really am concerned that nothing be done that can be avoided on the interest rate side. I thank you very much for your observations. Thank you, Mr. Chairman.

Chairman **Chiles**. Thank you. Senator Conrad.

HIGH INTEREST RATES

Senator **Conrad**. Mr. Volcker, I want to strongly echo the comments both of the chairman, in terms of outlining a long-term plan that locks us in to dramatic reductions in the deficit, and also the comments of Senator Domenici. Because I, too, believe fervently that it would be a disaster if we saw higher interest rates at this time. It would absolutely undermine everything I think this committee is committed to achieving in terms of deficit reduction.

I come from a State that is an agriculture and an energy producing State. Not many people think of North Dakota that way. But I can report to you that we are in the deepest recession since the 1930's, and we simply cannot tolerate any further pressure on interest rates. In fact, we need a further sharp reduction in interest rates in order for people to get through this crisis.

I know that that means we have got to bring deficits down. I think every member of this committee knows that those deficits have to be brought down, and brought down sharply. These deficits are keeping real interest rates high. I think Senator Domenici is correct when he outlines the other reasons for high real interest rates.

DOLLAR OVERVALUED

That leaves us with a dollar that is overvalued. And I was interested in your comment on page 5 of your statement about the dollar. I would like to hear more from you on that question, because in my view, unless the dollar comes down against those with whom we compete for agricultural markets, specifically, we are going to have a very difficult time in rural America.

And I understand your concern about the dollar coming down too sharply and the confidence that would cost us among those from whom we have to attract dollars to finance this deficit. But at the same time, the dollar is still relatively overvalued, it would seem to me, against the currencies of those countries with whom we compete for agricultural markets.

I would like to hear your analysis of the dollar.

CURRENCY VALVES HAVE LITTLE EFFECT ON AGRICULTURE

Mr. **Volcker.** Well, let me say first of all I certainly understand you come from a part of the country that has got a double whammy, and conditions are depressed. I want to observe that that is not true, of course, of the whole country. As you are well aware, other parts of the country are enjoying a very high level of prosperity.

What that is characteristic of is very uneven conditions throughout the country. I do think that there are dangers in the dollar declining too far too fast. I think that judgment is in accord with the discussions that were held last weekend and generally shared by our leading trading problems.

Now, you have the particular problem of agriculture. I sometimes think the effect of relative currency values on that problem are considerably over-emphasized. I think there is a severe problem in agriculture, not just in North Dakota and in the United States, but around the world in terms of a worldwide imbalance, currently, between supply and demand. I do not know how long that will last, but every agricultural producer around the world, from the United States and Canada to Argentina and Australia, as you know, is forced to adjust to a very difficult circumstance.

Traditional big importers—China, India, and so forth—have also increased their production. They are no longer big importers. We have an imbalance that I do not think is going to be cured, certainly not in the short run, by changes in exchange rates. I think that is the hard fact of the matter.

Senator CONRAD. Let me just go further, because I do not think it is just agriculture. When I look at the trade deficit I have to believe, from every analysis that I have read, that the value of the dollar has played a significant role. Other factors as well, no question about it.

Mr. VOLCKER. No; I do not question that. I think that is more true in the manufactured goods sector than it is in agriculture, frankly. And—by historical standards—we have had a very sharp decline in the dollar relative to our major industrial competitors.

AMONG AG COMPETITORS DOLLAR VALUE HIGH

Senator CONRAD. But if you look at the dollar relative to the currencies of countries with whom we compete for agricultural markets, you see quite a different pattern emerge. That is, very little reevaluation of the dollar.

Mr. VOLCKER. I do not deny that. Of course, Europe is a major agricultural competitor too, and we have had a big change there. But relative to Argentina or Australia or Canada, we have not had a big change. But, you know, what is produced in agriculture is going to be sold, by and large, particularly by other countries. We do the storing.

And if there is a worldwide surplus, I think whatever the exchange rates, you are going to have problems.

In the United States and in Europe we provide a lot of assistance to agricultural producers. I do not think in that sense it is basically an exchange rate problem. Now, the exchange rates will affect the relative cost of production over a period of time, but they are not going to affect the volume of production in 1987 or 1988 very much.

And it is that worldwide imbalance between supply and demand that——

Senator CONRAD. I could not agree with you more. In terms of price levels, I think clearly we have an imbalance between supply and demand. In terms of who moves their product in the marketplace, the differential value of the currency——

Mr. VOLCKER. I think even there it is not going to make much difference. I mean, Argentina is going to sell its crop. Australia is going to sell its crop. Canada is going to sell its crop, and Europe is either going to sell it or dump it. And we have long been in the position of being a marginal supplier, in a sense, to world markets, and when that world market is in oversupply I think we are in trouble, regardless of what the exchange rates are.

Chairman CHILES. Senator Rudman.

Senator RUDMAN. Thank you, Mr. Chairman.

JAPAN AGAIN PROMISES TO STIMULATE ITS ECONOMY

Chairman Volcker, the story out of Paris is that we are going to call off efforts to drive down the value of the dollar in return for which the West Germans and the Japanese have made a commitment to stimulate their economies in an effort to relieve our trade deficit. Now, we have heard these promises from Japan several times before with no results.

What is there about the circumstances today that would improve the likelihood that Japan will follow through on this promise?

Mr. **Volcker**. I think the simple facts of what is going on make me more hopeful. There is kind of good news and bad news. In both Germany and Japan, the latest indicators of economic trends have been indifferent, to say the least.

There are indications of rather sluggish economic activity, in part—maybe even primarily—because their trade situation in real terms seems to be turning around. They are having more difficulty exporting after these exchange rate changes, which is natural, and in a sense, the object of the changes. They are, at least in Germany, importing more. That has an impact on their domestic economic activity, which is slowing down.

So I think it is fundamentally in their own interest to expand internal demand, which is, of course, what we would like to see, and that will facilitate these adjustments. And I am hopeful that that situation is coming home more clearly to them. I think it is understood intellectually and will provide the base for actually supporting the expansionary actions that they talked about last weekend.

AS DOLLAR DECLINES JAPAN ADJUSTS PROFITS

Senator **Rudman**. Well, if in fact they do accomplish that expansionary action that was discussed in Paris, one of the problems that we consistently encounter is that we do not see a corresponding decrease in our trade deficit as the dollar has weakened.

One of the reasons has been Japan's determination to maintain its market share in the United States. Japan simply makes adjustments in its profit margin and in real prices to the United States consumer. Thus, we do not see any significant improvement in our trade deficit with Japan.

Why do we think that will change?

Mr. **Volcker**. I think the observation you make is, of course, accurate. They are squeezed in our market in terms of profits, but they are very reluctant to give up the markets, or market share, and they are willing to proceed at a much lower, or even negative, profit levels for a while. But you can only do that for so long. These processes take time, and I am hopeful that as a few more months or quarters pass we will see the results more clearly. I think we do see some glimmerings now.

The other side of the equation, I think, is at least as important—that these adjustments will not come through clearly unless those countries are willing to import and not just from the United States. They should be willing to import from countries like Korea or Taiwan or Latin America that need to increase their exports, and in turn, those countries may import from us.

There is clearly a much greater incentive now for those countries to import more from abroad. And you see that from Germany in particular. But is also a question of trade barriers. And whether they are explicit or implicit, you have got to deal with that trade barrier problem.

UNITED STATES MAY NOT BE BENEFICIARY OF PARIS AGREEMENT

Senator **Rudman**. Chairman Volcker, you have obviously anticipated my third question. One of the problems I have with what has happened in Paris—I do not criticize it. I think you have got a good agreement if it works. The problem I have is that the beneficiary of what you did might be Korea or Taiwan, not the United States.

Mr. **Volcker**. Well, except to the extent it helps third countries it will help us, because we are in a more competitive position to export to Latin America or to Korea or Taiwan. They can do things themselves. But we would like to see a shift in their exports more to the surplus countries and a shift in their imports to us. And the exchange rate changes facilitate that.

But that process also has to be facilitated—or at least not thwarted—by trade barriers.

Senator **Rudman**. Well, we hope it works out. Let me just go to another subject very quickly.

SHOULD DEFICIT TARGET BE CHANGED

We all agree that the purpose of Gramm-Rudman-Hollings was to get the deficit on a downward plane—there is no magic in particular numbers.

But as you said, I think, very eloquently, every institution must have its targets. That is a new experience for the U.S. Congress—not entirely a pleasant one for some people—but we do have our targets. The chairman of the committee, Senator Chiles, and the chairman of the House Budget Committee, Mr. Gray, have suggested changing the targets this year to what they consider a more realistic number.

There is some logic behind what they are suggesting, but some of us are rather nervous that if you change the target, the target will be missed by a corresponding amount, whether the target is higher or lower. My feeling is that if you open that crack a little bit, there are people in Congress that will not go through the crack, they will take the door off the hinges on their way through.

I would just like to know your general comment as to whether or not you think we ought to lower the target, or keep it where it is. We know we are going to miss it. I will say that here. But the question is, would we rather miss $108 billion by $30 billion or $135 billion by $130 billion; I would like your comment on this.

Mr. **Volcker**. Well, I sure do not want you to miss $135 billion by $30 billion.

Senator **Rudman**. Thank you, Mr. Chairman.

Chairman **Chiles**. Senator **Dodd**.

Senator **Dodd**. Thank you, Mr. Chairman.

Let me just pick up on Senator Rudman's last question, if you would. Too often we do not run a continuum here in questions, but we have all talked—the CBO baseline is now $169 billion, I think, the most recent estimates.

No one seems ever to ask, and as one who supported Gramm-Rudman-Hollings——

Chairman CHILES. CBO now says we are $171 billion.

IMPACT ON ECONOMY OF MEETING TARGET

Senator DODD. $171 billion. So, that would make it $63 billion, I guess, I am looking at. What are the impacts? We never ask this question, I suppose. What is the impact in a 1 year, $63 billion—assuming we do not do anything on the revenue side, let's just assume we go at budget cutting--what are the impacts, either on interest rates, or in terms of a recession, if you have a $63 billion cut in the budget in 1 year?

Mr. VOLCKER. Well, it depends partly on how you did that, and I can get into this asset sale question and other things. But the impact on interest rates is obviously favorable. You could raise, conceptually, the notion of whether it is not possible to overdo it, and the speed of the adjustment might precipitate a leveling or even a downturn in the economy. I think conceptually that is possible.

In practice, I guess I would return to the comment that Senator Domenici mentioned earlier. I really do not worry a great deal that you are going to overdo it and by the size of your budgetary effort precipitate a recession.

Senator DODD. But you think we ought to try and do it, thought, hit that $63 billion?

Mr. VOLCKER. I am convinced that if you do all you can practically do politically, it will not be too much.

Senator DOMENICI. Would the Senator yield for a clarification? Did you mean to imply that if it was $63 billion—is that the number you are using?

Senator DODD. Well, I thought it was $169 billion, so I was using $61 billion, but since it is $171 billion, it would be $63 billion.

Senator DOMENICI. Well, did you mean to imply that macro-economics-wise that it might have a more detrimental effect if all of that was off the cut side than if it was off the cut side partially and added taxes on the other?

Senator DODD. Well, there is a possibility. That is the question. I do not think that anyone knows for certain the answer. You can create a recession. There can be a recessionary impact at the time when you may need revenues to support an awful lot of activities that you would not otherwise need. You have that potential problem. You cannot avoid that.

Senator DOMENICI. Surely I did not want to use your time, but I do not have any empirical knowledge that we are that good of magicians where we can match up the dilatory effect of tax raising versus the dilatory effect of cutting budgets. It may be that we are smart enough to do that.

On the other hand it may be that you need programs because of problems.

THIRD WORLD DEBT

Senator DODD. Exactly, that was my point. I thank the Senator.

Let me just quickly—we are brief in time—I do not think I am going far afield here at all because we are obviously going to be impacted by third world debt issues, and I know you have testified on this. In fact, you did before the Banking Committee in brief the other day.

We have a tendency to focus on our debt issues as, I guess, our own Federal deficit as being the debt issue. But obviously, there is tremendous record-high consumer debt, corporate debt. FSLIC is in trouble. Farm credit is in trouble. Bank failures are at a near-record level, I guess, or at least approaching record levels. And obviously, the news the other day of Brazil—the largest international third world debtor country—and their decision not to pay interest payments.

Now, we have had this problem since 1982. We have had the Baker plan since October 1985, I think, about a year and a half now. What does the Brazilian decision say about the Baker plan? Is that Baker plan a failure, in light of the Brazilian decision, number one?

Number two, is there a Volcker plan? We might anticipate in this regard because I presume Brazil is only the beginning. Ecuador has made a similar decision, I gather, and I presume this will be something we will see from others.

You are going to be meeting with the Finance Minister, I believe it is, of Brazil sometime in the next few weeks, Mr. Funaro. Can you give us some indication of what you might be suggesting to him as to what Brazil might do? The question took the time, that is the problem.

Mr. VOLCKER. Well, so far as the general debt strategy is concerned, I strongly support the general thrust of the so-called Baker plan. I have no differences with that whatsoever. I think there are some difficulties at present in implementation. There is no doubt about that. I touch upon that in my full statement that I did not read earlier.

And those are most apparent now with respect to Brazil which has very large internal economic problems. But it is also apparent in many smaller countries where financing packages have not been put together with the speed and effectiveness that one would like to see, whatever the reason.

So there is a great need for a renewed thrust to this program and Brazil, in a sense, is the biggest challenge, the biggest debtor. A financing package in the case of Mexico, the other very large debtor, is just about in place, and one could argue the prospects are much more promising.

In the case of Brazil, I would point out that I think they have demonstrated in recent years that that is an economy of considerable strength and resiliency and there is no inherent reason why that economy cannot grow and generate the kind of trade surpluses necessary to service its debt. They have been doing it for several years.

Senator DODD. At our expense, too. I mean, it has cost us considerable.

EXCHANGE RATES SHOULD BOOST U.S. EXPORTS

Mr. VOLCKER. Well, at our expense in the sense that we have absorbed some of those exports, and I would like to see the rest of the world absorb more of those exports, which gets back to the exchange rate problem in part.

Senator **Dodd**. But they cannot afford our exports either.

Mr. **Volcker**. Well, they can afford our exports more relative to other countries with these exchange rate changes. We ought to be in a better competitive position. But you say how do we deal with this problem. I think you first of all have to establish a new base in Brazilian economic policy and performance so that one can then address the financing problem straight forwardly. That problem is sizeable there in contrast to what it was thought to be 6 months ago when it did not look like they would need much new financing.

They are clearly going to need new financing. But that has to be built on the foundation of a new economic program. So in that sense I think it is now up to Brazil, working, I hope, as much as possible with the international institutions to develop a sound economic program, first of all in their own interest. I think they have demonstrated the ability to combine growth with the generation of export surpluses that would permit orderly resolution of their very large external financing problem.

BANK STOCKS NOT PERFORMING WELL

Senator **Dodd**. Mr. Chairman, just one last question. The bank stocks did not perform well in the last several days, the news is, as a result of the Brazilian decision. Do you think this is a continuing problem with the private lending institutions? What do you anticipate will be their reaction?

Mr. **Volcker**. Well, I certainly think that this international debt problem has been a continuing problem for lending institutions, for the borrowing countries, and for financial markets.

Senator **Dodd**. Is there a willingness on their part to continue to participate; that's my question.

Mr. **Volcker**. Well, I have the feeling, that very real progress has been made over the past 4 years. It does not look like quite a big a crisis as it was in 1982. It has kind of dulled the incentives to cooperate, to make adjustments, to move ahead. And that very attitude has contributed to the present problem.

There are too many unresolved but potentially quite readily resolvable financing problems sitting around right now. And that adds right now—given the difficulties in Brazil—to a sense of very strong uneasiness, reflected among other things, in the price of bank stock.

So I do think there has to be a renewed effort here based upon renewed understanding that everybody is either going to fail or succeed together in this effort; the creditors and the debtors alike. And there better be a renewed sense of momentum and cooperation.

We are suffering to some degree, I think, from battle fatigue. But we better not let the battle fatigue get the best of us. I do think that this is a resolvable problem and a lot of progress has been made, both from the standpoint of reducing the relative exposure of the lenders in the potential for difficulty, although it is still very substantial, and from the standpoint of the borrowing countries in beginning to make some very fundamental needed reforms in their own economic structure.

People tend to overlook the fact that there have been significant moves—never as fast as you would like to see, sometimes two steps forward or one back—toward opening up those economies in Latin America, more liberal outward-looking approaches in policy, progress in dealing with subsidies and other market distortions.

In fact, I think there has been more progress—not yet absolutely firm, we cannot relax—in Latin America toward fundamental economic reform than at any time in the past 50 years. And I do not want to lose that.

Senator DODD. Thank you, Mr. Chairman. I apologize.

Chairman CHILES. Senator Nickles.

Senator NICKLES. Mr. Chairman, thank you very much. And Chairman Volcker, one, I want to welcome you to the committee, and two, I want to thank you. I think you have cooperated in many cases where we have had some troubled banks in our State. You have assisted us in those efforts, and we are still going through some difficulties, as you are well aware of.

Mr. VOLCKER. You are, indeed.

Senator NICKLES. But I thank you for your efforts, past and present. I would like to follow up on a couple of statements and comments that have been made. We have a lot of very serious problems in the economy, not just in energy and agriculture, but the Farm Credit Administration is in serious trouble to the tune of billions of dollars.

The S&L industry, likewise, is looking, for Federal assistance to the tune of several billion dollars. International banking problems—which Senator Dodd brought up and I caught part of your comments in your statement—particularly Brazil's nonpayment moves me to think that internationally there are certainly some problems.

BANK EXPOSURE IN THIRD WORLD NATIONS

Secretary Baker testified this morning before the Foreign Operations Subcommittee that he thought some progress had been made in the last few years. You mentioned that the international banks have less exposure today in the Third World countries than they did, say, in 1982.

Mr. VOLCKER. In relative terms, relative to their capital or assets. It is roughly half. Foreign banks, probably less than that, more progress than that. American banks, maybe on balance, a little less. But exposures relative to capital or relative to assets—which is really what counts here in terms of their own stability—have gone down sharply and steadily.

In absolute terms, exposure has gone up a little. But even in absolute terms it hasn't gone up much, if at all, in the last couple of years. And even in absolute terms it may have been down last year.

Senator NICKLES. Well, I was interested in that, because it seems like to solve these previous crises they usually end up rolling over unpaid balances or delinquencies and refinancing them.

Mr. **Volcker**. But there is no question that existing debts by and large have been restructured. That is why the absolute volume of lending has not declined appreciably. But meanwhile, they have been increasing their capital, increasing their other assets.

So if you look at it in a relative sense, there has been a big change; in an absolute sense, not much change, some increase over the 4-year period; in relative terms, a big reduction.

INTERNATIONAL BANKS NOT REGULATED

Senator **Nickles**. Concerning the regulations of the international banks and these loans, are they not classified or not regulated in any manner whatsoever?

Mr. **Volcker**. No; they are regularly reviewed. Some of them may be classified. Most of them are not classified according to the strict definition of the term classified. There is a separate review system for these international sovereign loans. They have characteristics, of course, that are not quite like an ordinary commercial loan, and they are reviewed, specifically and independently, apart from the regular loan review process that is applicable to commercial borrowers, whether they are at home or abroad. But they are reviewed and sometimes classified.

NO COLLATERAL OR CAPITAL TO BACK LOANS

Senator **Nickles**. You mentioned that they are sometimes classified. As you know, there has been extensive review and classification of loans—ag loans, energy loans, you name it—by the regulators on the domestic side. I have had the impression that the scrutiny given on foreign loans has been almost non-existent and that a lot of international banks are carrying loans that basically, if they were reviewed in a comparable method, one, there is not existing collateral or capital behind those loans, and two, they do not have capital reserves set up for those loans.

Mr. **Volcker**. Well, I know that impression exists and I do not think the impression is correct, but it is very deeply held by some agricultural borrowers and by some energy borrowers. When you are talking about these sovereign loans, they do not have some of the ordinary characteristics, obviously, that an agricultural loan would have.

There is no mortgage on property. There is no crop there to take as security. There is no security for these loans in that sense. So you, basically, have to make a judgment about the prospects of the loan being serviced over a period of time and whether a country is capable of doing that and willing to do it. And that is the kind of review that is made periodically for all of these loans. And a judgment is reached.

LOANS WRITTEN OFF

Senator **Nickles**. Have the international banks been writing off some of these loans that have been non-current?

Mr. **Volcker**. The noncurrent ones, yes. There is a fair amount of loans made abroad to commercial borrowers. And, of course, those are treated just like a loan to any other commercial borrower. Then you have the criteria of payment, and a good many of those loans, in the case of some countries, have been written off because the commercial borrower himself is bankrupt or unable to pay.

Now, sovereign loans, in some limited cases, have been written off too. In some limited cases, they are directed to, if not write them off, write them down. That has not been true of the major borrowers where the loans have been serviced.

SOME LOANS WRITTEN DOWN

Senator NICKLES. I would think in the case of a lot of the major borrowers—sovereign loans—that the banks would be prudent in at least writing down some of that paper.

Mr. VOLCKER. Well, we certainly do not discourage reserving against those loans. And while it is not usually the practice of American banks that they allocate general reserve provisions to particular loans—and they have domestic loans problems, too, as you know—it is encouraging that bad-debt reserves of American banks has increased very decidedly during this period.

And indeed, their overall capital positions have increased, not just in absolute terms, but in terms of relationships to the rest of the balance sheet. So, I do not think it is correct to say that there has been no progress in reserving and no progress in strengthening capital positions. There has demonstrably been progress in those directions.

Senator NICKLES. I thank the chairman.

Chairman CHILES. Senator WIRTH.

Senator WIRTH. I pass to Senator EXON.

Chairman CHILES. Senator EXON.

Senator EXON. Thank you very much, Mr. Chairman.

FOREIGN INVESTMENTS IN UNITED STATES

Welcome, Mr. Volcker. We are always glad to have you in front of our committee. You have always been very helpful and informative and you have helped guide us.

I would like to go back to try and get a situation as to what the picture is right now. The Washington Post, quoting you on February 1984, said that: "Volcker, addressing the 100th meeting of the National Governor's Association."

The National Governor's Association is going on right now 3 years later. At that time, Mr. Volcker, you supposedly told the National Governor's Association that: "The U.S. economy is being held hostage by foreign investors helping to finance America's borrowing needs, and the situation could soon reach crisis proportions."

Ever since that time, I think it is fair to say that the investment of foreigners into our system has gone up significantly. In fact, we now have shifted to the world's largest debtor nation.

I listened to your warnings then. I listen to you concerns now. Are things so much out of whack that conventional wisdom does not seem to always play out as we work our way through our domestic and international monetary difficulties?

UNITED STATES LIVING ON BORROWED TIME

Mr. **Volcker**. Well, I am sure that is true, as a generalization. Conventional wisdom sometimes does not work out, whatever that is. I do not know what conventional wisdom is now, but I would suggest it is kind of common sense—if it is not conventional wisdom—that we are living on borrowed time when we borrow about $150 billion a year from abroad.

I do not know how long it can go on. It has, obviously, gone on longer than I might have suspected when I made those earlier statements, for a variety of reasons. But I do not think it can go on forever. Maybe it will go on for another year, maybe it will go on for another 3 years. But if it goes on for another 3 years we will have dug a bigger whole for ourselves 3 years from now, and when it does change it could change all the more abruptly and with all the more difficulty.

I would point out, if I can draw an analogy, we are not a Latin American country, we are not Mexico or Brazil, we are much stronger. But some aspects of human nature, I suppose, continue. Those countries could borrow money very freely for about a decade, at progressively lower rates.

Mexico was borrowing money freely in the markets at a low spread as late as February 1982. When the market closed up on them, it closed with a vengeance. The psychology changed. There was a loss of confidence in Mexico, and suddenly a country that could borrow money freely—I think borrowed $20 billion in 1981, net—suddenly, 12 months later, could not borrow anything. And we do not want to leave ourselves in that kind of a position.

TAX SHORT-TERM STOCKS

Senator **Exon**. Mr. Chairman, one of the leading financial experts of the world today, who happens to be from my State of Nebraska, Mr. Warren Buffet, made a proposal recently that I would like to get your reaction to. He suggested that to stop the wile speculation that seems to be affecting our stock markets today, and indirectly our whole monetary system, that he felt that the tax laws should be changed to require a 100-percent tax of all stocks that were purchased unless they were held for 1 year or more.

What is your advice on that pretty revolutionary but rather interesting proposal about Mr. Buffet that I am sure you have heard of. And if the Finance Committee in the Congress should take such action, do you think that would be a good thing and would it possibly lead to a more stabilized stock market and possibly the elimination of some of the unsatisfactory procedures that are taking place on Wall Street today?

Mr. **Volcker**. Well, I have great respect for Mr. Buffet's investment judgment, from what I have read of it, and, I think, his common sense. That would, obviously, be an extremely drastic change in tax policy, and I do not think anybody could foresee all the repercussions. But his concern, I think, is obvious—and I would share it—that the very short-run focus by the investment community and by businesses in terms of what happens and what fees may be involved and what capital gains may be involved over the next 2 weeks or 2 months, he suspects—and I also suspect—that this very short-term focus sometimes distorts evaluations of more permanent values in the market and can end up generating more debt. People kind of frantically search for these short-term gains and end of weakening the economy rather than strengthening it.

But whether a 100-percent tax on short-term capital gains is the answer, with all the by-products that that would have, is a very difficult judgment, to say the least.

PROSPECTS OF LATIN COUNTRIES ON DEBT

Senator EXON. Mr. Volcker, what do you anticipate in the foreign situation with the announcement by Brazil? Are there other Central and South American countries that are very likely to follow suit? We had always anticipated that if a country like Brazil took the action that they did take there might be some kind of a domino effect. Is that a concern of yours?

Mr. VOLCKER. Well, I think that is always a potential problem, but let me not exaggerate it either. Brazil has been in arrears before, and other countries have been. As they run into a particular internal crisis they are not generating the foreign exchange necessary to pay their debts. If they straighten out their policy and get refinanced, the potential crisis eases.

And, of course, that is what I would hope and expect would happen here, but it is going to take a lot of effort. And there are other countries—as I indicated earlier, I guess, in my colloquy with Senator Dodd—that are not in a secure financial position. They have much easier problems economically, in most cases, and in a number of those cases, the creditors and the borrowers are very close to reaching agreement. I would hope and would expect that this action in Brazil would not disrupt those negotiations—if they go forward. I think it is in the interest of the debtor as well as the creditors that they do.

Senator EXON. So you are somewhat upbeat on that right now?

Mr. VOLCKER. Well, I do not know that upbeat is the right word, because I think this is a continuing major problem that must be dealt with forcefully. And as I said earlier, if there is too much battle fatigue after dealing with it for 4 years, that is a very dangerous situation. And I think what the Brazilian situation should do is remind everybody of the importance of continuing to deal with this in a cooperative way, and I think right along the lines of the Baker plan. All of those presumptions are still valid. We have to get to it and implement it.

Senator EXON. Thank you. My time is up. Thank you, Mr. Chairman.

Chairman CHILES. Thank you. Senator Grassley.

HOW CONVINCING IS BACKING OFF TARGET

Senator GRASSLEY. My comments are a little bit along the same line as what Senator Rudman stated, and I guess I would only add that we have an institutional problem here that we are tied to a narcotic of optimism, that it is very difficult for us to wean ourselves away from.

We seem to 1 year say that deficit targets are very achievable, and then the next year we are out here to say that they are not achievable.

I discussed this last week with Dr. Penner, when he was before another committee, about the effect of Congress abandoning its targets. And I think that some of the blame rests with those that we rely upon for judgments about the future.

And, of course, most of these targets were fixed using data that is very unrealistic estimating. And in my opinion, the problem of slackening the targets that we are talking about this very day and was in the morning Post quoting the chairman of the committee, is the same problem with underestimating the deficits that we have had over the last several years.

It has been a problem for us going all the way back to 1981, as far as I am concerned. And the end result is that they both become very elusive. So my question to you—and by the way, it is based upon what I was led to believe that you had said both in testimony and before you came here, that you mentioned that the targets are not in and of themselves important but that what is important is convincing the markets that deficit reduction will be sustained.

If that is a fair conclusion, then my question is if the targets are slackened, just how convincing can Congress be, for the benefit of the markets, that deficit reduction will be sustained? And I guess I would be asking you, then, a reaction to my view. I think that that would be like sounding a retreat if we were to do that.

Mr. VOLCKER. Well, I can recognize your problem psychologically and politically. On a kind of relative order of importance, I think you can be convincing. It depends upon what actions you take. Convincing not that you have met particular targets and maybe stretched certain assumptions in order to say that you have met them, and then it turns out you have not met them.

If you make realistic assumptions and take demonstrably effective action to produce a substantial reduction in the deficit—and to the extent the actions you take will carry forward into future years—so that you have laid a base for future reductions, then I think you have done a credible job.

You have done what the situation requires, and you will get a better effect in some sense from that, if you are really convincing, than simply printing that you have met a particular budget target and the nature of the actions does not seem to support credibly actually meeting the target. That will not help credibility. And if it does not have a carry-through to future years, that also will undermine it.

So I recognize the value of setting out those targets. But now you are at the point where you have got to demonstrate to a skeptical audience that whether or not the precise target is met there will be a substantial and a continuing reduction, and I think that is the key.

SMOKE AND MIRRORS WON'T REACH TARGET

Chairman CHILES. If the Senator will yield right there, I think that is an interesting answer and, if I could—not taking your time—just say a little bit more.

What I hear Chairman Volcker saying is that it is more important if we come up with a credible plan that keeps us on the glide path Senator Domenici talked about and that we do it with dependable numbers rather than something like asset sales, smoke and mirrors, adding more IRS agents and saying that will get us more revenue.

In other words, that there is not as much a magic in the $108 billion, although it is a good target for us to shoot for. But what we are going to be judged on is the content of our package, our budget, overall, whether it really has us on this declining line, and whether it has a hope of being a multiyear package as opposed to being 1 year; is that correct?

Mr. VOLCKER. Yes; I do not want to be against more revenue agents. That might be a good idea. But I do think you have got to be sensitive to what Senator Rudman said, that if that process degenerates into saying you will reduce whatever figure he used to a deficit of $135 billion, I think was the number he used, but it is really $165 billion——

Chairman CHILES. Right.

Mr. VOLCKER. Obviously, I would rather have a number that says $108 billion that is really $135 billion. You have got to be very careful that the whole thing does not slide backward on you. So you have got to put all of the emphasis on the credibility and realism of the assumptions and the actions you really take.

Senator DOMENICI. Would the chairman yield to the Senator without losing his time?

Chairman CHILES. Yes.

HOLDING THE SPENDING LINE THE PROBLEM

Senator DOMENICI. Let me say, Chairman Volcker, I agree with the thesis that has been discussed here. But let me suggest one of the big problems we have. I am just going to give you a hypothetical situation. Somebody says "let's pick up $30 billion in new revenue."

We are not talking about new in terms of added to the base because of prosperity or that kind of thing. New, whatever. The OMB Director said gasoline tax the other day. The problem that I believe the Congress is confronted with in convincing the people, and most assuredly in convincing the President, is that the tax is an assured reduction for that first year in the deficit. But how do we get assurance that the rest of the budget is as sure as that for the next 3 or 4 years?

Now I hear this chairman saying a 4-year plan. That is the notion, but once you put the tax on you are assured of it, unless we invent some tax that goes on and off based upon our performance. So if you can come up with something that says, indeed, it is a real fix—and it is not only taxes that are the fix—you have got something going for you.

Chairman CHILES. I think you are right. I think we would have to be talking about a reconciliation that locks things in.

Senator DOMENICI. I thank the Chairman for yielding, and I thank Senator Grassley.

Mr. **Volcker**. Well, if I may just make one observation on that colloquy. Whatever you do you are going to have a job in making it convincing for 1 year, much less 4 years. And that is where the emphasis is going to be. But things happen in 4 years.

But I would agree with a comment you made earlier, Senator, as I look at the budget from less expertise and background than you have. I think there has been a result from your activities over the past 3 or 4 years, that in some sense the basic trend of spending has been cut down.

So you are now not dealing with a situation that in the absence of further action is constantly producing a bigger deficit. Maybe it is slightly tilted the other way, but you have got to give that a lot more thrust in that direction.

Chairman **Chiles**. Senator Grassley, go ahead.

REACH TARGET AND THEN ASSESS NEED TO SLACKEN OFF

Senator **Grassley**. Thank you, Mr. Chairman. I am a great believer in the process and I do not think we ought to surrender until this process called the budget process works a little further down the road a few months.

And I think that any indication now in February that the targets ought to be changed is not giving fair consideration to the process. It may be accomplishing the goals, but I guess I would just conclude by offering a word of caution to this committee, that a slackening of the targets right now, this very minute, is just simply going to make future targets down the road just as unachievable and contribute to the lack of confidence that people have in Congress' ability to do its job.

And that instead of making progress, if we were to slacken the targets this year, I think, as I indicated to you, we would be accepting surrender and sounding a retreat. And I do not think we ought to do that, first of all. And if it is necessary to do it, it ought to be necessary after we try to meet those targets.

Mr. **Volcker**. Well, again, I think there is a very real danger in kidding ourselves and sticking down a higher target and then no more meeting that target than meeting the $108 billion target. And I think you have to be very cautious about that. And as you know Secretary Baker last weekend reaffirmed, essentially—somebody did the arithmetic, I guess the chairman—that the 2.9 percent of GNP that he cited is still his target and the administration's target.

Chairman **Chiles**. Two-point-three.

Senator **Grassley**. By the way, where is your cigar?

Mr. **Volcker**. I am trying my hardest not to stick it in my mouth. [Laughter.]

Chairman **Chiles**. I assume that was your last question. Senator Sasser.

Senator **Sasser**. Thank you, Mr. Chairman. Chairman Volcker, I understand before I arrived here that you indicated that it was not necessary——

Chairman **Chiles**. Excuse me, excuse me. I did not realize Senator Wirth passed over to Senator Exon. I made a mistake there.

Senator GRASSLEY. Well I would be delighted to yield to Senator Wirth.

Chairman CHILES. Please excuse me. I had forgotten you passed over.

Senator WIRTH. Senator Exon had been here before I was. Thank you Mr. Chairman.

FUNDAMENTALS OF TRADE PROBLEMS LIE IN DEFICIT

Chairman Volcker, we are delighted to have you here and as ever, your judgment and wisdom is respected so broadly. We appreciate your coming up here. I suspect you are battle weary as well, just as many of us are who have been through this. But I think you are absolutely correct that we have to be very careful not to, in your words, slide backwards.

I would like to inform my colleagues that I just came from a markup of the recommendation coming to the Budget Committee from the Senate Armed Services Committee in which the Senate Armed Services Committee has agreed by a vote of 18 to 2 to send over a recommendation of 3-percent real growth in defense. And in addition to that we took no action, at this point—it is hard to do early in the game—to the bow wave, which is another problem that we are going to have in the future. So we have got some real problems of backsliding on the whole budget issue, making our problem over here even more complicated.

In any case, Mr. Chairman, we hear a great deal about the trade deficit and that was very much part of the President's state of the Union message. He sent up a very broad competitiveness bill. There is a competitiveness caucus here, and a lot of discussion about the need to be much more aggressive on trade, to make a variety of investments, to look more at fair trade, and so on.

It seems to me all of that is very important, but in effect, most of those actions are really nibbling around the edges. The fundamental cause of our trade deficit goes right back to the domestic deficit. Were the budget deficit smaller, the trade deficit would be smaller. Too often we tend to get hooked up into the fashion of the time, which is to talk about competitiveness and talk about some of the relatively minor initiatives—each of which is important, but relatively minor—when we, in fact, should be addressing ourselves to the domestic deficit.

One, I would like your reaction to that. And second, perhaps to quantify it, what do you think our trade deficit would look like if, for example, our budget deficit were $100 billion, or if our budget deficit were zero? What would that impact have on the trade deficit?

Mr. VOLCKER. Well, I think you have to make a lot of other assumptions as to the setting in which that takes place.

Senator WIRTH. Of course.

Mr. VOLCKER. But broadly, I would agree there is a connection. What we have to do—it is inescapable—is to slow domestic consumption and domestic growth in favor of external growth if we are going to deal with the trade deficit, by definition. And part of the process of slowing domestic growth constructively is, certainly, dealing with the deficit.

How else are we going to slow it? Senator Domenici does not like higher interest rates and tighter money, and that is not the way to do it in a pinpointed way, anyway. To get this slower growth in domestic consumption you have got to remove some domestic stimulus to be replaced with stimulus from the trade deficit side.

Clearly the instrument for doing this most effectively is the budget deficit. That is one side of it. The other side of it—deferring capital inflow—is related to the trade deficit. Assume there was not a connection, just for the purposes of discussion, between the budget deficit and the trade deficit, but you deal with the trade deficit by some other means. Let me just make that assumption.

I think there is a connection, but assume there is not, and the trade deficit declines. By definition then we will have no capital inflow from abroad. How, then, are we going to finance the budget deficit? We are not going to be able to finance it without extremely tight money squeezing out other investments, which we do not want to do.

So however you look at it, if we are going to deal effectively with the trade deficit, I think the corollary is we have to deal with the budget deficit, or we are going to be in a mess.

Senator WIRTH. Part of that as well, has our net investment position not changed dramatically in the last few years? As I understand it, over a long period of time from very soon after the Second World War until the early 1980's we have accumulated a very solid investment surplus and our net investment was positive just about every year——

Mr. VOLCKER. That is correct.

Senator WIRTH. And in fact, averaged about one-half of a percent of our GNP. That was true up until 1981 and then we went into a very, very rapid decline over that next 6-year period of time; is that not correct?

Mr. VOLCKER. That is correct, so we now have a sizeable deficit position which is being added to, of course, every month and every year. That, you might argue, is all right, if we were having a great surge in productive investment in the United States, and if we were really employing this money in ways that we are going to help growth over a period of time, but, of course, we are not. It is largely going into consumption, basically.

IMPLICATIONS OF DEFICIT ON STANDARD OR LIVING

Senator WIRTH. Well, what has that meant, now that we have this enormous trade deficit? As each of us has the obligation to try to explain, as Senator Grassley was pointing out, to the American people what is going on. Clearly, what we have to do is slow down consumption. But if we do not do that, what are the implications of this enormous deficit and this continuing deficit for the American standard of living, long term?

Mr. VOLCKER. Well, long term you have got to assume that as the interest bill paid to foreigners gets bigger and bigger we are clearly eroding the potential standard of living for the next generation. Next generation may sound too far off. It may be closer than that. We are living—in a very literal sense of the word—on borrowed money.

FOREIGN INVESTMENT HERE HURTS THERE

Senator **Wirth**. And this has got to be made clear that borrowed money, it seems to me, also has—as you have been discussing here this morning—very, very broad implications for the ability of foreign countries to invest and produce there. If their capital is leaving there and coming here, what we are doing is, in effect, robbing them and their productive capability to pay for our consumption; is that right?

Mr. **Volcker**. That is right. Well, you may argue—I do not know whether I would use the word robbing—that we are certainly using some of their savings. It may be at a time when they were not prepared to use them at home, but as their own economies grow, if they do stimulate their economies, they are going to need more of their savings at home, which will make it tougher for us to borrow.

And the more we are dependent upon those savings, the more of a problem we are going to have in a world in which they want to use their own savings at home. Part of the reason this money has come in so freely is that they have not been growing very fast. There have not been very big demands on their own internal capital markets, so the money could come here freely. But that is not going to last forever.

SCENARIO FOR HIGH INTEREST RATES HERE

Chairman **Chiles**. So part of what you are saying is, if they do what we want them to and stimulate their economies——

Mr. **Volcker**. Precisely.

Chairman **Chiles** [continuing]. Then they will have more need for this money——

Mr. **Volcker**. That is right.

Chairman **Chiles** [continuing]. And then the very thing that Senator Domenici and all of us worry about, our interest rate may go up——

Mr. **Volcker**. That is right.

Chairman **Chiles** [continuing]. To have to attract their money, unless we are at least coming down with our needs for that money.

Mr. **Volcker**. That is the whole scenario that one would like to see, that they move ahead and stimulate their own economies, which has the correlation that they will use more of their savings at home. We relieve those pressures by reducing our demands on the world capital markets by reducing our deficit. You know, we are so big, relative to other countries, and we are importing so much money, the amount that we are importing is not an insignificant part of the world capital outflows.

I think there are estimates that it may be as much as 20 percent of the savings generated by our principal trading partners that is flowing here. Well, you cannot count of that forever.

Senator **Wirth**. Thank you, Mr. Chairman.

Chairman **Chiles**. Senator Kasten.

DO NOT CHANGE DEFICIT TARGET

Senator **Kasten**. Mr. Chairman, thank you. I want to point out that I believe there is magic in the $108 billion Gramm-Rudman target. And I think it is important that we do not start to develop here a concern or an impression, Mr. Chairman, that you are saying Congress should drop the Gramm-Rudman process.

I think there is magic in the $108 billion even if it is really $135 billion, because we have for the first time been able to approach this problem in terms of setting some real limits on us. We go out there on the floor and we say you have got to have an offset for that increase in spending.

There is a whole process that has taken place here, and if we drop the $108 billion, what we are saying is that we no longer believe in the rest of it. And I also do not see anything to take its place.

Mr. VOLCKER. I understand your concern, Senator, and I get increasingly uneasy as I sit here because, while I think it is substantively true that the fortunes of the nation do not depend upon reaching $108 billion, I also sense that by giving up that concept or target, you may forego, in political terms, the chances of reaching what would be a respectable number in terms of a final realistic outcome.

I think you have got to make the challenge high in order to reach the right result, and I know all of the pressures that exist in terms of spending, the difficulties of raising revenues. I sure hope that nothing I say can be interpreted as any relaxation on the basic effort, because my whole testimony would be counterproductive if that is the way it is interpreted.

Senator KASTEN. I appreciate that clarification.

Senator DOMENICI. Would the Senator yield just for a moment. I have been listening and I surely did not read the chairman to say that we ought to waive the $108 billion target. Certainly, I hope nothing that my friend, the chairman of this committee has said indicates that. I will ask him for his own comment shortly.

Frankly, we do not have anything credible around considering these processes. I know, one, you know, year to year basis, we do not have anything credible around other than that, to the extent that it is credible. It is more than anything else.

DON'T RELY ON FOREIGN PROMISES TO CUT MONEY SUPPLY

Let me make one other observation, Mr. Chairman. You have been off trying to tell Japan and Germany that they have got to start their economies growing and consuming more at home. Nobody disagrees, that I have heard of, but I hope we are not counting on that to happen quickly, and as a result curtail our consumption by cutting our money supply.

Because we have been asking them to do that for a couple of years. I was there 18 months ago. The head of the major party and the head man in Japan said they were going to do it. They have not done much yet.

The same thing in Germany. Their growth is negative. Their consumption is down internally. And clearly we cannot trade those office too quickly without performance on their side.

Mr. VOLCKER. Well, I agree with you in general. I think you overstated what is going on there. Their internal demand did go up last year and their trade balance in real terms declined. So I think there is some progress. But it is also true that the rate of growth has been diminishing recently.

U.S. ECONOMIC CRITICISM JUSTIFIED

But, you know, what we hear from them all the time—and I cannot lay my hand on the exact sentence they put in my statement at the moment—but their story always is, you always want us to do these things and tell us we are not doing anything. We do not see you doing anything. It is your deficit—it is your two deficits, the trade deficit and the budget deficit—and we would feel more comfortable about doing something here if we see real action on your side on the budget deficit.

And I think that is not entirely an unfair comment. We are the biggest, strongest country, presumably, supposed to be leading the world, and we are not very credible when we go around telling them what to do, unless we can do that from a platform saying we are doing our part. And while we made progress this year—we are going to have a reduction in deficit this year—it comes to a pretty skeptical audience. I think we have now got to show that progress is going to be carried through, and then out platform for talking to them is immeasurably enhanced.

TARGET BUDGET PACKAGE NEEDED WITHOUT GIMMICKS

Chairman CHILES. I want to say to my good friend from New Mexico—if I might just again ask you to yield, and we will certainly give you some time—I concur with what the other chairman said, Chairman Volcker, the big chairman——

Senator DOMENICI. The tall chairman.

Chairman CHILES [continuing]. Big and tall—that we should not be waiving the $108 billion. I think it is a good target. It is one that has invoked some discipline and helped us in the right direction. I think, at the same time, to try to establish our credibility, we have to recognize some of the difficulties in getting there and call the numbers like they are.

I would like to see us put together a package that allows us to say, Mr. President, if you used your own budget assumptions on this package, we will be where you are or lower. But we are not going to say we have arrived at some magic number when we truly know we have not. We will call it like it is. But we would say, at least, we are going to go where you have gone. Senator.

Senator KASTEN. Thank you. Thank you, Mr. Chairman. I appreciate all of the answers because I felt we were moving in a different direction a minute ago.

Mr. VOLCKER. I had the same uneasy feeling, as I said.

Senator KASTEN. And if there is not magic in the $108 billion there is a certain amount of magic in the process, at least right this minute.

Mr. VOLCKER. Exactly. I think there is magic procedurally and politically. Obviously, the economy is not going to turn on precisely $108 billion. But, in terms of process, it may be very important to keep that goal out there.

Senator KASTEN. But if we maintain that goal, we then, I believe, will maintain the process and maintain part of this political discipline that we have got part of—we do not have it all—but we are going to continually be working toward the goal. And I think it is important that we keep that goal, that target, in place.

Chairman CHILES. Senator Sasser.

DEFICIT REDUCTION THE TARGET

Senator SASSER. Chairman Volcker, if I understand what I am hearing here today about the Gramm-Rudman-Hollings targets, I get the impression that your view is the most important thing is to continue to bring the deficit down?

Mr. VOLCKER. Creditably and effectively and to the maximum extent you can.

Senator SASSER. And bring it down using genuine numbers, not phony numbers. And before this committee a couple of days ago a distinguished economist, Dr. Martin Feldstein, indicated that he thought it would be adequate, by means of deficit reduction, to hit somewhere in the neighborhood of $130 to $140 billion. That is above the Gramm-Rudman-Hollings targets to some extent.

But I assume you would not disagree with his view as long as we were using creditable arithmetic to get to those targets, because we would be bringing the deficit down and in the long term that is what needs to be done; is that an accurate assessment?

Mr. VOLCKER. Well, you make some assumptions there which I have to emphasize. If they are really credible based upon conservative economic assumptions and that you really have those actions in the bag, then $130 billion still looks a lot better to me in that context than $140 billion. A number lower than either of those figures would look still better to me.

Senator SASSER. But it would not be a misstatement to say that you would value a $130 or $140 billion deficit—you would think more highly of one that reached those numbers in a genuine way than one where we met the Gramm-Rudman-Hollings targets using numbers that were suspicious or one-shot sale of assets and that sort of thing that really in the long haul did not help us much from the deficit standpoint; is that an accurate assessment?

Mr. VOLCKER. Well, I think it would be accurate to say I would prefer a realistic $130 billion to $108 billion that was realistically $150 billion.

Senator SASSER. All right.

Mr. VOLCKER. I mean, I think the answer to that is obvious. But to reach the $130 billion you may have to have a $108 billion target.

Senator SASSER. All right. I just want to get away from this business that you have got to get down to $108 billion in deficit, whether in reality it is or not.

Mr. VOLCKER. I guess all this argument is what kind of a target you want to set for yourself, recognizing that realistically there may be some questions about the solidity of any of the numbers. And I certainly am not against setting yourself a low target. And I think you have a target that in those terms you are going to have to explain yourself against, anyway.

DEVALUED DOLLAR DIDN'T HELP TRADE DEFICIT

Senator **Sasser**. Now, one of the most serious problems facing this economy and this Congress is the problem of the huge trade imbalance. We have seen the value of the dollar peak relative to the other major currencies in February 1985, and we have seen a rather dramatic decline in the strength of the dollar since then.

Now, unfortunately, 1986 was a rather disappointing year as far as the performance in our trade deficit was concerned. When do you think we can expect a turnaround in the trade deficit, and what do you attribute our continuing poor performance, given the fact that the dollar has come down rather dramatically?

Mr. **Volcker**. Well, I am expecting to see some improvement this year, but I have to make a technical point in that connection which I think is often overlooked. When we are talking about improvement in the trade balance, particularly in terms of its real effect on the economy, you are talking about real imports and real exports and the relationship between the two.

One thing you can be quite certain of is that the price of our imports is going up. It is going up and it is going to continue to go up because of the change in the value of the dollar, so improvement——

Senator **Sasser**. Well, let met just say——

Mr. **Volcker**. If I can just complete the point, Senator Sasser. We can get an improvement in our real trade balance without getting an improvement of the same magnitude or no improvement at all in these monthly trade figures you see which are in nominal dollar terms and reflect the increased price of imports. That might lag further along before you get a real turnaround there.

IMPORT PRICES NOT DECLINING WITH DOLLAR

Senator **Sasser**. Well, you know, heretofore when we have seen a rise in the value of the dollar we have seen a fall in the value of imported goods. And I was looking at some statistics the other day.

Now, in the period spanning the first quarter of 1977 to the second quarter of 1980 the exchange rate of the dollar fell almost 12 percent. The inflation adjusted price of foreign goods in the United States rose by 9 percent.

Mr. **Volcker**. What period?

Senator **Sasser**. This was from 1977 to 1980—the first quarter of 1977 through the second quarter of 1980. We saw the dollar falling by 11.5 percent, to be precise, and the inflation adjusted price of foreign goods rose at 9 percent, which is about what we would expect.

Then in the period spanning the second quarter of 1980 to the first quarter of 1985, the dollar rose by about 46 percent, the inflation adjusted price of foreign goods fell by almost 30 percent, which again is what we would expect. As the dollar goes up you would expect the inflation adjusted price of foreign goods to come down.

But what we have seen between the first quarter of 1985 and the second quarter of 1986, with the dollar declining by about 26 percent, the inflation price of foreign goods has also declined. Not by much, by about eight-tenths of 1 percent, but it has declined.

And historically we would have expected the inflation adjusted price of foreign goods to go up as the dollar was declining. Now, what is the explanation for this, Mr. Chairman?

Mr. VOLCKER. When did you end that last time period?

Senator SASSER. The last time period I have here is the first quarter of 1985 through the second quarter of 1986.

PROFIT LOSSES PAYING FOR DOLLAR DECLINE

Mr. VOLCKER. Well, I would have to look at just how your computations were made, but your precise calculations roughly correspond with a more general observation I will make—that decline from the very peak levels of the dollar, which after all were not in effect very long, did not change import prices as sharply as one would expect normally on the basis of historical experience, because foreign profit margins were, obviously, extraordinarily wide at that point.

And as one of the Senators mentioned earlier, there has been an intense effort to maintain market shares. So for a while in this decline in the dollar, that effort to maintain market shares to absorb what I think of as excess profits meant that the decline in the dollar was not fully reflected in import prices.

But it is also—and this just gets to a technical question of what indices you are using—my impression that if one took 1986 as a whole, import prices of goods were increasing a lot faster than domestically produced goods prices. I thought they went up in the area of 7 to 10 percent on import prices when——

Senator SASSER. Well, to be fair, my numbers just include the second quarter of 1986. They do not include the third and fourth quarters.

Chairman CHILES. Thanks. Senator Danforth.

WHAT IF WE HIT THE REAL TARGET

Senator DANFORTH. Mr. Chairman, we have been going around and around about the $108 billion target. I just want to ask the witness one other question to clarify it in my own mind.

Some people think that we should pull away from the $108 billion target because it would be bad for the economy, because it is too low to hit for the economy and because it is said that it might cause a recession if we were to hit the $108 billion target.

Now I am talking about real money, a real target of $108 billion. If we were to hit a real target of $108 billion, in your opinion, would that be bad for the economy?

Mr. VOLCKER. Not if you began right now. And I could imagine circumstances—but it is just realistic to think of it—where you kind of go off the table on October 1, 1987 and suddenly had a big increase in taxes and a big reduction in expenditures, which would be disturbing coming all in one big lump in a quarter.

I think, clearly, you can overdo it in that sense. But if you really went at it and began making these reductions, not quite that abruptly, and we knew it was happening, I think the economy could adjust, although that would be a very big reduction for one year. And it would imply a big adjustment.

My fear is not that, but that you will not come anywhere near that amount in real terms.

Senator **Danforth**. I understand. I am an advocate, myself, of the $108 billion target because I think once we start welshing on Gramm-Rudman, we have had it. I mean, I just do not think we can say, well, we really did not mean it. I mean, last year the target was $144 billion, but we really did not mean $144 billion, we meant $154 billion, which turned out to be $169 billion.

Mr. **Volcker**. Or higher, right now. You are starting from a much higher base than you assumed when the $108 billion was made.

Senator **Danforth**. Right. But you do not think it would be a disastrous thing or that it would push us into a recession if we were to reaffirm now the $108 target for fiscal year 1988, a real budget deficit of $108 billion.

Mr. **Volcker**. I guess I have a good deal of skepticism that you can reach it.

Senator **Danforth**. You know, politically it is a problem, but economically, is it?

Mr. **Volcker**. I think you have to measure what you do, I suspect. I think that is the lesson of what people are saying here, that you have got to measure what you do against that $108 billion, or otherwise the whole process will lose credibility. But I cannot tell you, honestly, that the fortunes of the economy rest upon reaching $108 billion in the terms that you are defining $108 billion.

Senator **Danforth**. But it would not be a bad thing if we hit it?

Mr. **Volcker**. No; I think we could manage that. I think it would take more aggressive policies in some other directions, including abroad, if we did it; go back and tell our trading partners, you may not have thought we could do that but we are doing it and you better take that into account in your policies.

Obviously, it would have implications—that strong a move—in the level of interest rates and for monetary policy.

VALUE OF ASSET SALES

Senator **Danforth**. Do you think asset sales count?

Mr. **Volcker**. Well, yes and no. They count in technical budgeting, the way the budget law is.

Senator **Danforth**. I know, but as a matter of policy?

Mr. **Volcker**. I think it does not help much, obviously, in terms of the pressures put on credit markets. I think the philosophy toward asset sales ought to be governed pretty much by whether you think it contributes to better and more efficient government.

And I can understand the argument. You can argue both sides of it.

Senator **Danforth**. Sure.

Mr. **Volcker**. But if you sell loans into the market you have a measure of market costs. You have a measure of the subsidy that the government is providing, and the net result of that will be more efficient, effective government, in the sense that the cost of government will be better measured. I think that is the true debate about asset sales.

Senator **Danforth**. But it is not a budget debate? I mean, you would not view it as——

Mr. **Volcker**. I think it is less so a budget debate.

Senator **Danforth**. I mean, you would not view this as the answer to the budget deficit?

Mr. **Volcker**. No; the fact is that you have got to finance an asset sale just like you have to finance Treasury bills.

Senator **Danforth**. Mr. Chairman, just one other question. We now have what, a $2 trillion debt?

Mr. **Volcker**. Yes.

SIGNIFICANCE OF PLAN TO LIQUIDATE DEBT

Senator **Danforth**. Let's suppose we have a $2 trillion debt and we have no intention of ever paying if off. What does that mean to the future of the country? What is the significance of a $2 trillion indebtedness with no real plan or concern about paying it off?

Mr. **Volcker**. Well, I think we can manage that. That is essentially the way we have been operating for 20 years, at successively higher levels of debt. A $2 trillion debt in an economy of $4.5 trillion and growing, we can manage. It is a choice over a period of time, if you pay off some of that debt you would probably create a better climate for domestic capital formation, which should have favorable implications for long-term growth.

But just simply maintaining—if you maintained it at $2 trillion—the economy is going to be growing and over time you would have relieved the relative debt burden quite substantially. I think we can manage that debt. What causes the problem is the rate of change in the debt, not the absolute amount in a growing economy.

We have not exhausted, I think, fortunately, the limits of the debt that we are able to carry in a growing economy. It is the rate of speed at which we have been adding to it that creates the problem.

Senator **Danforth**. Thank you, Mr. Chairman.

USE OF ASSET SALES IN SETTING MONETARY POLICY

Chairman **Chiles**. Thank you.

How do you consider asset sales in setting your monetary policy? You said that monetary policy is dependent in large measure upon what the Congress and the President does in fiscal policy. If we give you a fiscal policy based on a large measure of asset sales, does that give you the ability to relax your monetary policy? Or would you be concerned about that monetary policy reigniting inflation? Would it cause problems with our foreign creditors if we relied on a more liberal monetary policy based on asset sales?

Mr. **Volcker**. Well, I think the answer would be the latter to some extent, if they were really big. I have to tell you in all honesty that it doesn't make a lot of difference one way or the other.

Chairman **Chiles**. Yes, sir.

Mr. **Volcker**. It is just not big enough in the total magnitude of the problems that we are dealing with.

Chairman **Chiles**. But if we said we are going to give you a revenue quotient in our package of $15 to $18 billion and most of that is going to be asset sales and one-shot propositions, how would you view that?

Mr. VOLCKER. Well, in terms of its impact on the money markets and the kind of problems we have to deal with, I would tend to discount that component.

ECONOMY CAN'T STAND HUGE GROWTH IN DEBT

Chairman CHILES. All right. You talked about managing the $2 trillion national debt. My understanding is you say yes, we can manage it. Can we manage a $2 trillion national debt growing at $150 billion to $200 billion every year?

Mr. VOLCKER. No; the whole thrust of my statement and testimony is no.

Chairman CHILES. You are saying we cannot manage a policy that accumulates $1 trillion in 200 years, then adds another trillion just 6 years later?

Mr. VOLCKER. No; you come back to Senator Wirth's observations. I think that is part and parcel of the distortions and imbalances that we see in the economy generally, most explicitly the trade deficit that everybody is very unhappy with, and rightly so.

MUST TAKE CARE OF DEFICIT BEFORE DEBT

Chairman CHILES. Well, let me ask you then one further question in this area. If the $108 billion is a good target and we should not abandon it, would it also not be a pretty good target if this country was on record as saying we do not intend to continue even a $2 trillion national debt? We are going to try to go into some policies that have us paying off that debt. Would that not be a pretty good national policy?

Mr. VOLCKER. That is pretty good to me. I do not think it is practical for a good many years.

Chairman CHILES. In other words, first we have got to manage the deficit at hand.

Mr. VOLCKER. I will begin believing that if I see the sustainability and the adequacy over the next couple of years.

THE UNFAIRNESS OF OPENED DOOR TRADE

Chairman CHILES. All right, sir. As you know, I have a strong interest in trying to take down trade barriers. If we are going to be competitive, it will not do us any good unless we can kind of get our foot in the door. We are talking about a trade bill, and I hope the thrust of that trade bill will be to demand open markets all around.

Last December I wrote you a letter about the rapid influx of the foreign firms into our financial markets and worried that we were not getting the same green light abroad. I was opposed to us giving primary dealer status to two Japanese security firms this last December. Mr. Corrigan made that policy, and he assured me that we were going to keep the pressure on them to open up their markets and that we could even rescind the dealerships if progress was not made.

Can you tell me how we stand on that and whether the Japanese have taken any tangible specific steps since December to open up their markets to our firms.

Mr. VOLCKER. As I recall it, they did take some steps in early December. There is no question that over the past year or so, in the past 6 months, they have taken a number of steps to go in the direction of opening their markets to foreign securities firms, American and otherwise, and taken some actions to liberalize the powers that American and other foreign banks exercise in Tokyo.

There is no question at all there has been progress. On can, obviously, talk about the degree of that progress, and I am sure there is more to be done, but there has been progress.

WHEN MUST JAPANESE TRADE PLUG BE PULLED

Chairman CHILES. I thought I heard Mr. Corrigan say that and I told him I thought I heard him say that. He probably differs from what I heard him say. But I hear us say over and over again, well, we are going to allow the Japanese to do this—in this instance, license these two firms—but we have told them that this is the last step. Unless they take some actions on this we are really going to get tough.

And I do not put all of that on Mr. Corrigan. I have heard that statement—it has come out of my mouth before, I am afraid to say—on some trade pitch or something else. We are really going to crack down on them, but we are going to allow this to happen. At what stage do you think we should say no, no, no. We are not going to allow this to happen. You show us positive action and then we will allow it to happen.

Mr. VOLCKER. Well, I think we do not face that issue quite as starkly as you pose it because they have been taking some actions in this particular area. Again it is a matter of degree.

Chairman CHILES. When they take action in the citrus area, they do it an orange and a grapefruit at a time. That is what they call action.

Mr. VOLCKER. Exactly. This arises in area after area, and I think areas that have much larger implications for American employment and growth than a couple of Government securities dealers.

But the issue that you pose is a very real one. We face it in the banking area all the time. We are, I suppose, basically biased in being hesitant to make that decision because we do operate under laws and policies whose fundamental premise is that our market is open. And in the banking area that is quite clear. The law says that.

Chairman CHILES. And that has been part of our problem. How long are we going to operate——

Mr. VOLCKER. All I am pointing out is as an administrative agency in that area, the law directs us to give so-called national treatment to——

Chairman CHILES. But the law also allows you, or the policy allows you to come to us at any time and say we would like to have a little more discretion here.

Mr. VOLCKER. I, in fact, have said that at times.

Chairman Chiles. Any time you are ready to say that, Mr. Chairman, I believe there are some people here that are ready to listen.

Mr. Volcker. Well, this issue has come up from time to time before the Banking Committee and there has been some discussion of it. The reason it was rejected when the International Banking Act was passed is there are very real difficulties in that kind of tit-for-tat reciprocity provision. Markets differ, institutions differ, it is very hard to measure. You get in kind of a mess.

Chairman Chiles. Mr. Chairman, at some stage I think we have got to risk getting into a mess.

MULTILATERAL SUPPORT NOT GOOD IDEA

Mr. Volcker. Now, one criteria you can use for this kind of thing—it is not an easy answer—but do we have such a good case that we can get multilateral support for it? We not only take the action, but other trading partners take the action.

Chairman Chiles. If you are talking about multilateral support for our action, I do not think that is a very good criteria. If you are talking about multilateral support for what they are already doing in their markets, that is a pretty good action, because I think if you look what our trading partners are doing, they are already playing hardball individually, bilaterally, and they do very well with it.

But when we say, we want you to back us up, wait a minute, that is a different tune.

Mr. Volcker. Well, in the financial area that I am most familiar with, these kinds of concerns that you have in connection with this reciprocity in terms of the government securities dealers, I can assure you, are felt very strongly by other European countries. They have the same concerns that you have, and you could argue that some of them may have been more effective at negotiating with the Japanese in resolving some of their concerns.

Chairman Chiles. I guess that is what I am trying to say. I believe they have been more effective.

Mr. Volcker. I do not know whether that is true in general. We have the problem in another form now, frankly. This is exactly a protectionist issue, but our banks compete around the world—obviously with other international banks—and if the ground rules for that competition are not reasonably evenhanded and consistent with safety and soundness we have a problem.

And we have taken some steps to make our capital requirements more consistent, explicitly with those in the U.K., which is a leading banking power. But it is very important, I think, that they be made consistent with those under which Japanese banks operate so that they do not have an unfair competitive advantage and that their activities do not undercut our standards which are there for safety and soundness purposes. So we have got a lot of problems in these areas.

Chairman Chiles. I know we do. Mr. Chairman, just to sum this up, I think and I certainly hope, we would hold up further entrance into our financial markets if they do not reciprocate. I think as long as we base it on some future action they take it will never get——

Mr. VOLCKER. Well, I understand your concern, but we are not based entirely upon future action. There has been progress and I think we can list that.

ADMIRE JAPANESE

Chairman CHILES. Lest I sound like I am doing a little bashing here, I tremendously admire the Japanese. I want to emulate them a little bit. I am ready to follow their lead in some of these and I think that much of what they are doing is very consistent with what our past policy has been. In effect, we have wrung our hands and we have talked about what we are going to do and we have never taken any action.

They are sensitized that this is part of what these fellows have to do. They have to talk about it. But they are not really serious because they never take any action. Therefore, we are sort of encouraged to continue to do these things.

So I think they are creatures of what our response has been in many ways. We have got to show them that we are prepared to make a different response.

Mr. VOLCKER. I understand.

Chairman CHILES. We thank you very much for your appearance here today and for your forthright answers. You are always very helpful to us as we continue our deliberations.

Mr. VOLCKER. Thank you.

[Whereupon, at 12:15 p.m., the committee adjourned subject to the call of the Chair.]

COMPETITIVENESS AND TRADE

THURSDAY, FEBRUARY 26, 1987

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee convened, pursuant to notice, at 9:42 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Lawton Chiles, (chairman of the committee) presiding.

Present: Senators Chiles, Sasser, Riegle, Lautenberg, Simon, Sanford, Wirth, Conrad, Domenici, Grassley, and Danforth.

Staff present: Richard N. Brandon, staff director; and John Hilley, assistant director for macro-economics, trade and finance.

For the minority: G. William Hoagland, staff director; and Gail Fosler, deputy staff director and chief economist.

OPENING STATEMENT OF CHAIRMAN CHILES

Chairman CHILES. Good morning. This morning, we welcome to the committee a panel of expert witnesses to discuss our country's ability to compete in world trade.

With us today is Dr. Pat Choate, author of several books including the widely acclaimed, "The High-Flex Society." We also welcome Dr. Lester Thurow of MIT, one of the Nation's leading economists. His recent book, "The Zero Sum Solution," is a timely and insightful study of U.S. competitiveness. Also joining us will be Robert C. Holland, president of the highly regarded Committee on Economic Development.

In many ways, each of you have become prophets with honor in your own country, and each of you have played a major role of making a national issue of our ability to compete in the modern world.

JAPANESE QUESTION OUR MANAGEMENT

But you have had some help, and from an unlikely source. The Japanese Foreign Trade Council has prepared an analysis of our competitive decline. Among other things, their reports question our management of basic industries. It says our companies have cut back direct investments and sought joint ventures which have increased our imports at the expense of our exports. And the study refers to the deindustrialization of our economy.

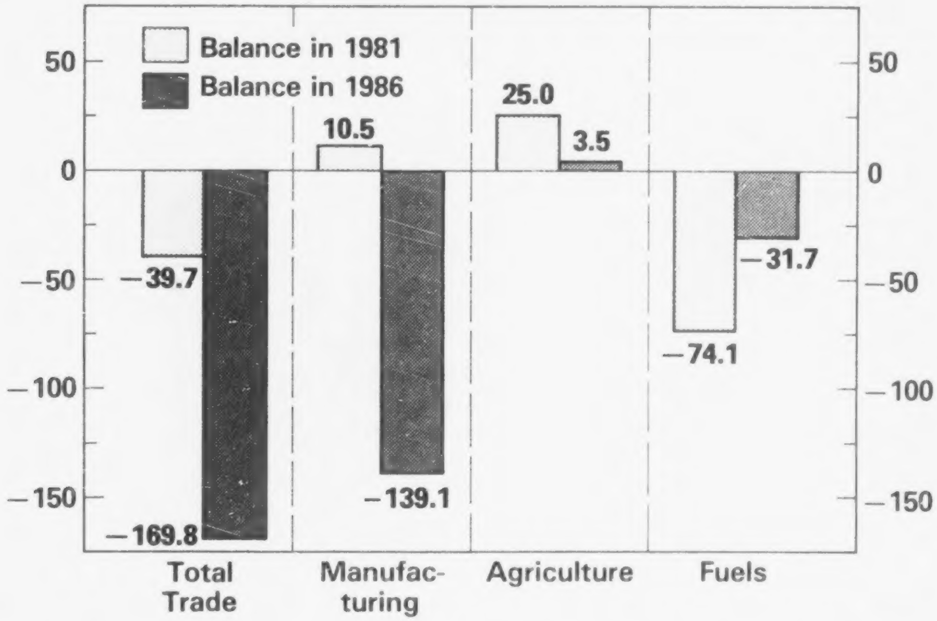
FALL IN OUR STANDARD OF LIVING

I think if we look at one of the charts we have up here, showing our decline in trade from 1981 to 1986, the total deterioration of

$130 billion in our trade deficit is more than accounted for by the $150 billion decline in manufacturing sector balance. That, I think, is what really shows us how dangerous this is and how devastating it has been to our economy. That is where the higher-paid jobs were in the manufacturing sector.

THE DECLINE IN TRADE, 1981 TO 1986

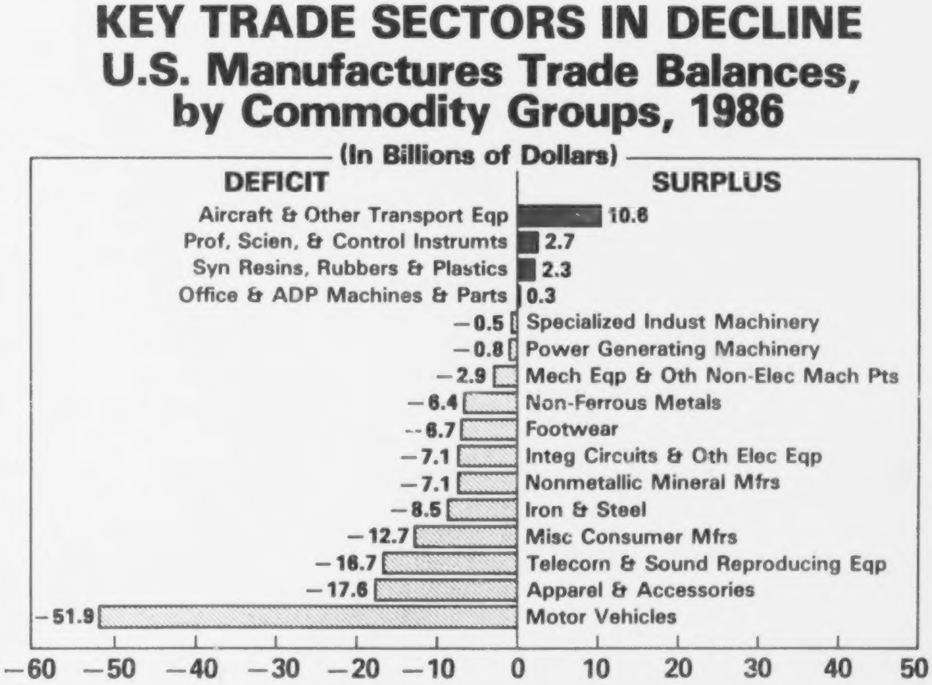
(In Billions of Dollars)



Chairman CHILES. When we look at the studies of the last 5 years, of the 8 million new jobs that we created, 60 percent of those jobs will be paying less than $7,000 a year. That gives us a pretty graphic picture when we see that manufacturing sector balance.

So a continuation of this downward trend in the high value-added manufacturing sector can only lead to a fall in our standard of living.

The other chart shows the key trade sectors in decline, and it is not just textiles and footwear. If we look, we see, it is all of the places where we once had big leads—specialized industrial machinery, power-generating machinery, mechanical, nonferrous metals, integrated circuits and other electric equipment. Now, of course, automobiles being our lead agency, we see what a disaster we have in that sector.



KEY TRADE SECTORS IN DECLINE
U.S. Manufactures Trade Balances, by Commodity Groups, 1986
(In Billions of Dollars)

R&D AND EDUCATION

Chairman CHILES. The question we need to address today is what are we doing about all this. For one thing, we are spending 1.9 percent of GNP on civilian research and development. Both Japan and West Germany are spending at least 2.5 percent.

Between 1955 and 1983, we increased the number of bachelor degrees in engineering from roughly 23,000 to 67,000. In Japan over the same time, the number rose from 10,000 to more than 73,000—Japan, with half our population.

Right now, over 43 percent of the engineering doctoral degrees in this country go to foreigners. But since 1980, only about 12 engineering Ph.D.'s from this country studied overseas. With the way things are going, you would think we might be a little more interested in what the competition is doing.

And what else are we trying to do? Well, the administration's budget wants to cut education funding 30 percent, reducing funds for vocational education by $4.2 billion over the next 5 years.

We are supposed to invest $6 billion for the Supercollider, but we can only afford another $50 million to improve math and science training in the elementary schools.

I think what we have here is a clash between the rhetoric and the performance. We have got a full choir, but an empty collection plate.

You have to wonder if we are going to spend all of our time discovering and rediscovering our problems without doing much about them.

It seems to me we have got to assert our economic power, the ability to deliver a rising standard of living on a sustainable basis. It means we will have to educate our students and retrain our workers. It means we will have to give those workers a say in the management of their companies and a share in the profits.

We need a new partnership of business, workers, government and universities to meet the demands of global competition. And we will have to invest in science and research and reward the creation of new capital, rather than endless mergers, before we become victims of Jonah's whale.

And of course, we have to cut the Federal deficit.

But now, all these things have become a familiar litany. With your help, we have begun to pin down the problems, but here in this committee is where the hard part begins. This is where we ask "How?" This is the place to ask "What do we do?" And this is the time to repeat some questions the administration once asked: "If not us, who? If not now, when?"

These are the questions we put to you this morning, and we look forward to your answers and your help in the weeks and months to come.

Senator Domenici, we are glad to welcome you and your opening statement. I appreciate this letter you delivered to me. It is a little late. I read it in the paper. That was a faster form of delivery, I guess, than can be made by hand delivery.

Senator DOMENICI. I was carrying it around yesterday afternoon, and I forgot to give it to you.

I told you about it, though.

Chairman CHILES. You did that, you did that. And I have an answer for you, and I do not know whether I should publish it or give it to you.

Senator DOMENICI. Why don't you wait until after the Tower Report?

Chairman CHILES. All right. That is right. It would not get much press now.

Senator DOMENICI. In any event the truth of the matter is, without trying to talk about how all these things happen, would you believe that sometimes these matters, even of as significant import as this, even when handled by the former Chairman, can get out of his control?

Chairman CHILES. I believe anything you tell me. [Laughter.]

Senator DOMENICI. Having said that, somebody around me here, knowing what I am talking about, would be on my side, not yours, incidentally.

Thank you very much, Mr. Chairman.

I understand Dr. Holland had a time misunderstanding and will be here at 10 o'clock.

OPENING STATEMENT OF SENATOR DOMENICI

Actually, I was going to just insert this statement, but frankly, I think I am going to share it, because perhaps it has a slightly different tone than yours; maybe not opposite of the coin. But competitiveness—we are all talking about that. I think I know that I am for it, and I think I know what it means. I think it has got 15 letters in it, and I think it is getting very close to being "apple pie and motherhood."

Competitiveness encompasses almost every range of national policy. Many of them are in very simple and basic terms, like the needs of Americans. I want to remind my good friend the chairman that in the past, we have had words like "re-industrialization" and "industrial policy." We even had "supply side economics."

A couple of other observations—they may be slightly different than those that you raise for the distinguished witnesses.

DATA DOESN'T SUPPORT INDUSTRIAL GLOOM AND DOOM

There is a great deal of consternation these days about America becoming a second-rate economic power. I hear it said, and I may even have in a speech or two used similar words by way of this change that is occurring, but I have heard it said that we are gutting our industrial base, and we are turning into a "Big Mac" economy.

I hear it said that large trade deficits kind of indicate that that is where we are moving.

Well, I am going to be honest with you, and perhaps the two of you can tell me if I am wrong, but I have asked for data with reference to this from all different sources, and I just cannot find data that I actually believe to sustain that proposition.

We have added more jobs than any other major industrial country. The proportion of industrial jobs to the rest of the employment sector in our country is higher than our competitors, not lower, even now. Ten million jobs in recent years, and many of them are in the manufacturing sector, have demonstrated that the manufacturing sector in the United States, from what I can find—and I ask the experts to tell me where I am wrong—has made remarkable productivity gains in the industrial sector of the United States.

I regret to make this next statement. I do not believe there is real hard evidence that the new jobs are bad jobs. I just do not find evidence of that that I believe.

I also do not believe we are measuring accurately what service jobs add to the productivity and growth. I think it is so different that we are not even sure we are measuring it.

There is some evidence that in the service end, there are some very high-paying jobs, and there is also evidence that in many of these service jobs, the wage base is growing much faster than wage rates in other traditional pay sectors.

That is not to say that we do not have problems; I really believe we do. But, I think they are also the result of dramatic change. I think change was going to occur. In fact, I would like to ask the two distinguished gentlemen that later on, after their testimony—was it not inevitable that dramatic change in the American economic situation would occur.

I close by saying I have no doubt that Mr. Volcker is correct, that Secretary Baker is correct, that the macro problems are tremendously important; the issue of our deficits is tremendously important, and that it is somehow tied in to Japan, West Germany and others in terms of how they are treating their economies in terms of growth, that that is all related.

I thank the chairman for the time, and the remarks that I did not give that are in the statement, I will edit myself and put in the record as a supplement.

Thank you, Mr. Chairman.

Chairman CHILES. Thank you, Senator.

[The prepared statement of Senator Domenici follows:]

OPENING STATEMENT

HEARING ON INTERNATIONAL TRADE AND COMPETITIVENESS

SENATOR PETE V. DOMENICI
FEBRUARY 26, 1987

MR. CHAIRMAN, LET ME ALSO WELCOME OUR WITNESSES THIS THIS MORNING. INTERNATIONAL TRADE AND COMPETITIVENESS IS A BROAD TOPIC, BUT CERTAINLY DESERVING OF THE ATTENTION OF THIS COMMITTEE.

THE PROBLEM THAT THIS SENATOR HAS IS WITH THE BASIC NOTION OF "COMPETITIVENESS". I KNOW I AM FOR IT; I THINK I KNOW WHAT IT MEANS. IT'S A 15 LETTER WORD THAT TRANSLATES INTO APPLE PIE AND MOTHERHOOD.

THESE DAYS IT SEEMS THAT "COMPETITIVENESS" ENCOMPASSES THE VERY BROADEST RANGE OF NATIONAL POLICIES -- MANY OF THESE POLICIES WE USED TO DISCUSS SIMPLY IN TERMS OF THE BASIC NEEDS OF AMERICANS. I WANT TO REMIND MY FRIEND AND CHAIRMAN, THAT IN THE PAST WE HAVE HAD OTHER BUZZWORDS SUCH AS SUPPLY-SIDE ECONOMICS, REINDUSTRIALIZATION AND INDUSTRIAL POLICY.

LET ME MAKE A COUPLE OF FURTHER OBSERVATIONS THAT THE CHAIRMAN MAY FIND A BIT PROVOCATIVE. BUT I AM SURE HE KNOWS I DON'T INTEND THEM TO BE SO.

THERE IS MUCH CONSTERNATION EXPRESSED THESE DAYS THAT AMERICA IS BECOMING A SECOND RATE ECONOMIC POWER. I HEAR IT SAID THAT THE LARGE TRADE DEFICIT IS GUTTING OUR INDUSTRIAL BASE AND TURNING US INTO A "BIG MAC" ECONOMY.

LOOKING AT THE DATA I DON'T THINK THAT IS TRUE. WE HAVE ADDED MORE JOBS IN THIS ECONOMY THAN ANY OTHER MAJOR INDUSTRIAL COUNTRY OVER THE PAST FIVE YEARS -- ALMOST 10 MILLION. AND IN RECENT YEARS MANY OF OUR MANUFACTURING SECTORS HAVE DEMONSTRATED REMARKABLE PRODUCTIVITY GAINS.

FURTHERMORE, THERE IS VERY LITTLE HARD EVIDENCE THAT THESE ARE "BAD" JOBS. WE HAVE A HIGHER PROPORTION OF OUR WORKFORCE EMPLOYED IN HIGH PAYING OCCUPATIONS THAN EVER IN OUR HISTORY. AND FOR THOSE WHO ARE EMPLOYED IN RELATIVELY LOW PAYING OCCUPATIONS, PARTICULARLY IN THE SERVICES SECTOR, THE WAGE RATES IN MANY OF THESE JOBS ARE GROWING FASTER THAN WAGES IN OTHER, TRADITIONALLY HIGH PAY SECTORS.

THAT IS NOT TO SAY THERE ARE NOT PROBLEMS. WE ARE IN THE MIDST OF CHANGE. AND FOR MANY WITH CHANGE COMES PAIN. MY HOME STATE HAS SUFFERED TREMENDOUSLY. THE NUMBER OF PEOPLE THAT HAVE BEEN DISPLACED FROM EXTRACTIVE INDUSTRIES IN THE WESTERN STATES HAS BEEN STAGGERING. AND I DON'T WANT TO SUGGEST FROM THESE STATEMENTS THAT WE ARE ALWAYS DEALT A FAIR HAND IN THIS INTERNATIONAL POKER GAME OF TRADE.

BUT, THE POINT IS THAT I AM CONCERNED THAT WE DO NOT TRY TO DEVELOP A SERIES OF MICRO POLICY RESPONSES, FOR WHAT TO MY OWN VIEW IS ESSENTIALLY A "MACRO" PROBLEM -- THE HUGE FEDERAL BUDGET DEFICIT. INDEED, WHAT I SEE IS A GROWING FRUSTRATION -- EVEN TO THE POINT OF DISINTEREST -- IN THE BUDGET PROBLEM AND A RUSH TO SUBSTITUTE A PATCHWORK OF HASTY "STICK IT TO THE FOREIGNERS" TRADE-RELATED INITIATIVES IN ITS PLACE.

TO THIS SENATOR, THE BEST TRADE POLICY IS BUDGET POLICY.

WE HEARD SOME VERY INTERESTING TESTIMONY ON TUESDAY FROM CHAIRMAN VOLCKER. HE MADE IT VERY CLEAR THAT MONETARY POLICY WOULD HAVE TO BE "REVISITED" IF WE WERE TO ADHERE TO THE GRAMM RUDMAN HOLLINGS PATH. THAT MEANS TO ME INTEREST RATES WOULD GO DOWN.

WHAT HE WAS LESS EAGER TO DISCUSS WAS THE FACT THAT, IN THE ABSENCE OF SUBSTANTIAL DEFICIT REDUCTION BY THIS CONGRESS, INTEREST RATES WILL GO UP.

FOR MY STATE AND FOR MANY OF THE STATES REPRESENTED ON THIS COMMITTEE, HIGHER INTEREST RATES WOULD BE A DISASTER.

I LOOK FORWARD TO THE TESTIMONY BY OUR WITNESSES THIS MORNING. I REALLY WANT TO SEE IF WE CAN DEFINE THIS THING CALLED COMPETITIVENESS.

BUT THE BUSINESS OF THIS COMMITTEE IS THE BUDGET AND, MORE SPECIFICALLY, DEFICIT REDUCTION. SO IN THE PROCESS OF THEIR REMARKS, I HOPE EACH OF OUR WITNESSES WILL DISCUSS THE RELEVANCE OF OUR COMMITTEE'S ACTIONS IN THE WEEKS AHEAD TO THE ISSUES OF TRADE AND AMERICAN COMPETITIVENESS IN A WORLD ECONOMY.

Chairman CHILES. Senator Simon had wanted to say something. Paul.

OPENING STATEMENT OF SENATOR SIMON

WHERE TO GET REVENUES TO REACH TARGET

Senator SIMON. Yes, and it will be very brief; and I apologize to Senator Sasser and the others. I have a mark-up in another committee.

If someone could put that previous chart back up there, the first chart, I think that is a fairly dramatic series of charts.

Two things hit me. One, coming from a State like Illinois, I see the difference in agriculture there. The second—and this is really why I want to have some comments from the two witnesses even though I am not going to be able to be here—is the fuels. It looks bad now, better than it was in 1981, but inevitably, that $31.7 billion deficit is going to grow and grow tremendously as soon as the price of oil goes up. And just as sure as we are sitting here, one of these days that price of oil is going to go up.

I have just read the letter from Senator Domenici and the other Republican members of this committee, and they say we want to hit the $108 billion target. To do that, we are going to have to have at least $30 billion in revenue.

I favor having that $30 billion in revenue. I think we ought to do everything we can to get that deficit down.

My question to the two witnesses and to Dr. Holland, if he joins us, is how should we move to get $30 billion in revenues.

And let me just add one aside. I am sorry Senator Domenici is not here, but his staff can pass this along to him. He talked about all these good jobs being created. In the last 5 years, 60 percent of the new jobs that have been created in this country pay less than $7,400. So they are jobs, and I am all for it, but they are not really what we ought to be aiming for.

Thank you, Mr. Chairman.

Chairman CHILES. Senator Sasser.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you, Mr. Chairman.

I want to welcome this distinguished panel here this morning—Dr. Pat Choate, who served with distinction for a number of years as head of the Economic Development Administration in Tennessee. In this position he helped lay the foundation for some of the progress we have made in certain areas in Tennessee; and also, Mr. Chairman, I want to welcome Dr. Lester Thurow. I think Dr. Thurow, to some extent, has been a voice in the wilderness for a number of years, and I think his predictions are now coming true in spades.

THE DEINDUSTRIALIZATION OF AMERICA EVIDENT

I want to respond just a moment to something that our distinguished ranking member said at the outset. He was indicating that we had created a substantial number of jobs in this economy. That is true, but as Dr. Thurow has been pointing out for a period of time, even before 1980, these jobs are being created in the less lucrative service sector of our economy. We have been witnessing to a substantial extent, the deindustrialization of the United States.

We now find that average family income, or median family income, which stood at $28,277 in the 1970's—and that is in 1985 dollars—now has declined to $27,735 for 1985.

So we are retrogressing in this country in real, disposable family income. I think that signals a significant economic and social problem for us. And this retrogression takes place even though more and more families now are turning to two-family wage earners, both husband and wife working.

And while many in this capital city were singing the praises of supply side economics and other, in my view, shallow economic theories, Dr. Thurow over the years has kept his eye on the ball and has had the courage and the perception to point out the real problems, the underlying weaknesses in our economy, and recently, in a very perceptive book, what should be done about it.

So I am delighted to have both of these distinguished gentlemen here this morning, Mr. Chairman. I welcome them to the committee and look forward to their testimony with eager anticipation.

Chairman CHILES. Thank you, sir. Dr. Thurow.

STATEMENT OF DR. LESTER C. THUROW, GORDON Y. BILLARD PROFESSOR OF MANAGEMENT AND ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

U.S. MANUFACTURING WILL RECOVER

Dr. THUROW. Let me start with the good news. U.S. manufacturing output is going to recover. The only uncertainty is the timing of that recovery and the nature of that recovery.

The recovery is certain because of two rules of economic arithmetic. First, no country can forever run a trade deficit, since to do so it must forever go into debt at ever faster paces.

The trade deficit and the interest that must be paid on accumulated debts must eventually exceed the rest of the world's willingness and ability to lend the requisite amounts.

Second, any country that has become a net debtor nation as the United States has must have a trade surplus for this is the only way that it can accumulate the funds necessary to pay interest on its accumulated debts.

As a result of these two rules, it is absolutely certain that the United States will eventually swing from a trade deficit to a trade surplus.

What is uncertain is the issue of timing. The United States will swing from deficit to surplus in its international accounts when the rest of the world is unwilling to lend the United States the sums it needs to borrow to run a trade deficit. At that point the dollar will fall however far it is necessary to eliminate the trade deficit and bring about the necessary trade surplus.

Since the world is on brand new financial ice—the world's wealthiest economy has never been the world's largest net debtor nation—no one knows or can know how long the lending will last. But what we do know is that the longer the lending lasts, the larger the U.S. debts will ultimately become, the greater the interest that will have to be paid on these debts, and the larger the ultimate U.S. trade surplus necessary to cover those interest payments.

AGRICULTURE A DISASTER

Because of the success of the green revolution in both the underdeveloped and developed world, the large export market for American farm products has disappeared for the foreseeable future. Net agricultural exports are down from $27 billion in 1981 to $4 billion in 1986, and the recent declines in the value of the dollar will do little to turn the situation around.

SERVICE EXPORTS

Excluding earnings on foreign investments and military transactions in the third quarter of 1986, the United States exported 52 billion dollars' worth of services. There is simply no way that these service exports can be expanded to cover the 504 billion dollars' worth of goods and services we imported.

Even more to the point, the United States ran a service trade deficit of $4 billion, importing $56 billion worth of services.

Since neither agriculture nor services exports can be expanded by sums large enough to cure America's $170 billion trade deficit, U.S. manufacturing will recover. Given that it takes 1 million full-time, full-year workers to produce slightly more than $40 billion worth of goods and services in manufacturing, at some point in time approximately 4 million jobs are going to be added to American manufacturing payrolls.

That is the good news. But there is also a not-so-bright side.

A DEVALUED DOLLAR WON'T DO IT

To say that U.S. manufacturing will recover based on a falling dollar is to say that U.S. manufacturing will recover by lowering its wages. A falling dollar is of course essentially a national give back. Viewed from the perspective of other currencies and from the perspective of American purchasing power, U.S. wages will fall. As the German mark rises from 3 marks to 2 marks to the dollar, a $10 per hour U.S. manufacturing wage falls from 30 marks to 20 marks per hour, and an American worker's ability to buy German goods falls by one-third.

The bottom line is a reduction in the U.S. standard of living.

To say that U.S. manufacturing will recover based on a falling dollar and lower wages is not to say that U.S.-owned manufacturing will recover. Japanese cars built in America may replace American cars built in America. When this happens, something is lost. At the joint GM-Toyota facility in California, for example, unionized blue collar workers are back at work. But all of the designers, engineers and top managers are Japanese. All of the very highest-paying jobs have been lost at that facility.

RECOVERY WILL BE IN LOW PAY MANUFACTURING

While manufacturing will recover, this is not to say that high-wage, high value-added manufacturing will recover. The recovery may take place in the low-wage, low value-added end of manufacturing. As manufacturing production moves from Japan and Germany to the United States, what part of manufacturing will the planners at MITI seek to keep? To ask the question is to answer it. They will seek to keep the high value-added, high-wage manufacturing and to lose, however reluctantly, the low-wage, low value-added manufacturing.

What determines whether a country is competitive in high-wage, high value-added industries, or balances its balance of payments based on low-wage, low value-added industries?

The answer is simple. Countries have a comparative advantage in high-wage, high value-added industries if they have the best labor force, the most capital equipment, the latest technology, and all working with good managers. I am not going to talk about private managers, since that is not something that Washington controls, but it should not be left out.

MUST BE COMPETITIVELY SKILLED

For the United States to be competitive in world markets and still pay its workers as high as the wages anywhere else in the world, it must have a work force that is as well-educated and as skilled as the best of its competitors, is investing as much in plant and equipment as the best of its competitors, and be devoting as many of its resources to civilian research and development as the best of its competitors.

If comparisons are made with our leading competitors, the United States now invests less in both plant and equipment and civilian research and development than either Germany or Japan. It does not take a genius to know that the United States cannot be competitive investing two-thirds as much as the Germans and half as much as the Japanese in plant and equipment. Nor can it long continue investing two-thirds as much in civilian research and development. Military research and development simply does not generate enough spinoffs to fill the gap between what they and we are investing in developing new civilian technology.

The central competitive problem facing the United States, however, is neither one of these two problems, as serious as they may be. Our central problem is the quality of our work force. It just does not measure up when it comes to skills and education.

At the college level, the problem is one of mix. Proportionally, Germany and Japan are graduating many more engineers and scientists than we are, and they do not use 40 percent of their engineers in defense. Given many more engineers, foreign products are better engineered than American products. It is that simple. Put bluntly, the United States needs more students in engineering schools and fewer talented students in law schools.

The real problem, however, lies in the education and skills of that 70 percent of the work force that will not get a college degree. They are much more likely to drop out of high school and perform relatively poorly in reading and mathematical skills even if they do graduate.

I subscribe to the Nihan-Kaiser-Schimburg, and the most recent issue was talking about a national disaster. The Japanese high school dropout rate went up from 1.9 percent to 2.0 percent. The

American high school dropout rate is 28 percent—14 times as high as that in Japan.

Once out of high school, there is no system for teaching the noncollege part of the work force the skills they will need both to get a job and to keep the United States competitive. The Germans have an elaborate apprenticeship system. Given lifetime employment, Japanese companies make much larger investments in training than American companies. With very high labor force turnover rates, American companies do not find it profitable to train, even when they cannot compete with the rest of the world because of lack of trained workers.

SYSTEM OF SKILL TRAINING NEEDED

If the United States is to be competitive with high wages, it simply must develop a system of skill training for the non-college-bound. Whole industries such as machine tools are becoming noncompetitive for lack of a skilled, but non-college-educated, work force. In the past, such workers could be attracted from Europe, based on higher U.S. wages. Those days are over, however, since European wages are now equal to or in some cases superior to those in America. From now on, the United States is going to have to grow its own skilled non-college-educated workers.

In 1983, public—Federal, State and local—subsidies to higher education amounted to $4,427 per enrollee. Essentially, the taxpayer on average provides a subsidy of almost $17,000 to every college graduate over a 4-year period of time. In contrast, in 1983, public investments in the labor training of those not going to college amounted to $368 for each of the noncollege youth between 18 and 24 years of age in the United States. Both equity and efficiency demand some redress of that imbalance.

Since the skills of the non-college group are best learned in an on-the-job context, some system of cooperative public-private involvement will have to be developed. Private firms can give the training, but the public will have to pay for much of it since firms cannot capture the benefit of training if individuals are to be left free to leave whenever they wish.

I personally prefer some system of individual education and training accounts where every U.S. citizen, those going to college and those not, would be given at age 18 a bank account where checks could be drawn to defray the costs of future education and training, but the precise system is much less important than having some system.

When it comes to the famous bottom line, American workers must be world class if the United states is to be competitive while paying high wages. What is true in international sports competition is equally true in the international economic competition that America now faces.

FIGURES BELIE MANUFACTURING COMPETITIVENESS

Let me make one final remark. It is true that productivity in American manufacturing looks good if you compare it with the rest of the American economy. If you have a whole economy growing at 1 percent productivity, and you have manufacturing at 2½, that sounds like a good number. But that is not the right comparison. The right comparison is what does American manufacturing do relative to the rest of the world.

The answer is that in Japan, manufacturing productivity is growing between 5 and 6 percent, twice as fast as it is in the United States. And what counts is not how well we do vis-a-vis each other, but how well we do vis-a-vis the rest of the world.

Chairman CHILES. Thank you, Dr. Thurow.

Dr. Choate?

STATEMENT OF DR. PAT CHOATE, DIRECTOR OF POLICY ANALYSIS, TRW INC.

Dr. CHOATE. Mr. Chairman, with your permission, I will submit my formal statement to the record and briefly summarize.

Chairman CHILES. Your statement will be included in the record.[1]

UNITED STATES SLIPPING IN GLOBAL ECONOMY

Dr. CHOATE. I would like to deviate a bit from that statement in my opening comments.

It seems to me, looking at the charts that were presented earlier, that we have rather dramatic evidence that the U.S. economy is neither performing as well as it has in the past, nor as well as our foreign competitors.

I think it important for us to distinguish between absolute and relative performance. What we see is, while the U.S. economy has been able to have real growth, and it has had expansion of various sectors, when we compare how the United States has done in the context of a global economy, we find out that we are slipping. In basic industries such as automobiles, we have gone from half the global production in the sixties to less than 23 percent today.

When we take a look at business services, we have gone from 15 percent in 1975 to about 7 percent today.

In high-tech trade, we find that we have slipped from a $26 billion surplus in the early 1980's to a $2 billion deficit today.

What this suggests to me is that perhaps we need to go back as a country and take a look at some of the basic questions. I think that too often the debate about our competitiveness has been couched in polar terms, such as manufacturing versus services.

SERVICE INDUSTRY RIDES MANUFACTURING WAVE

Well, when we take a look at our economy, what we see is that manufacturing contributes close to 30 percent of the value added in our economy and that manufacturing value added underpins a major part of the service industry. If that manufacturing base goes, so too will much of the service industry.

I think another distinction that we need to make is between industrial production and industrial employment. The only way that we can maintain the value added created by industrial production is to quickly automate our factories. In turn, that is going to mean smaller industrial production, which then brings us back to the question of how do we deal with the 2 million-plus workers a year who are going to be unemployed. How do they make the adaptations that are necessary to shift to other jobs?

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[1] See p. 314.

Senator DOMENICI. Excuse me. You said smaller industrial production. You meant smaller industrial employment.

Dr. CHOATE. Yes; smaller industrial employment.

Senator DOMENICI. Work force.

Dr. CHOATE. We will have fewer industrial workers drifting down from 17, 18 percent in manufacturing to maybe 10 or 11 percent—much as what happened in agriculture earlier, where you had fewer workers, but higher productivity.

The second false choice is between high-tech and basic industries. We clearly need both. Equally important, the basic industries, such as automotive production, are going to survive only if they can use more technology.

And the final false choice, I think, is between big and small industry. Big business amasses the capital, does the majority of research, engages in the global sales. Small business does a major part of the innovation and creates a major part of the jobs. It seems to me that there is a symbiotic, synergistic relationship between the two.

LOOKING AT THE FUTURE

Now, as we take a look toward the future, it seems also that the economy has all of the basic strengths that are necessary to be fully competitive. When I say that, I point to a book I wrote in 1981 called "American Ruins" about infrastructure. I only point that out to highlight the fact that I am not by nature an optimist, but when I look at the future of the American economy, I think we can have some optimism, because we have got the capital. We have got the technology and the ability to create more. We have millions of skilled workers. And we do have a fine set of educational institutions.

The question is, How do we deploy those assets? What are the barriers that are keeping us from deploying those resources in the manner that we need to meet the competition.

Well, I think there are several approaches we can take, but essentially they revolve around a two-part agenda, a linked agenda: one external, one internal.

WALL STREET OBSTACLE TO PROGRESS

Internally, it seems to me that the principal obstacle that we face, at least in the business community, to making the investments and undertaking needed actions are the enormous pressures that are faced by firms for short-term performance, quick results. A large part of that is coming from the radical shift that has occurred in the capital markets in this country, particularly in the ownership and what is done with the ownership of stock on the New York Stock Exchange.

Today what you find is that at least in our 200 largest corporations, 50 to 60 percent of their stock is held by financial institutions. What you also find is that 35 percent of all the stock on the

New York Stock Exchange is held by those financial institutions, and that they engage in really quick turnover.

As a consequence of that turnover, what we have seen is the entire value of the New York Stock Exchange which, in the early seventies was turning over only every 6 or 7 years, now turns over every 22 months. Given that, given the stock raiders, given the arbs, what we have seen is a dramatic diversion of capital to, I think, very unproductive uses. Specifically, in 1982–1983, we were having American corporations buy back about $25 billion of their stock each year. In 1984, 1985, and I daresay in 1986, although we do not have the numbers, American corporations were buying back over $100 billion a year of their own stock, rather than using that capital for investment in productive facilities.

If those pressure for short-term performance are reduced, I think you will see in effect more investment made in the types of activities that are important.

UPDATING THE WORK FORCE

Domestically, there are a series of other activities that need to be taken. As Professor Thurow suggests, there are a number of steps that we need to take to improve the competence of our work force.

The one thing that I would point out is that over the next 10 years, it is critical that we give the preponderance of that attention—or, if not the preponderance, at least extra attention—to retraining the adults in our society. Because of the peculiar demographics created by the post-World War II baby boom generation, almost 9 out of 10 of the people who will constitute our work force in the year 2001 are adults, and most are already at work.

Most of those workers can expect to change jobs three to six times between now and then. Most will require booster shots of education and training. Most will require other mechanisms to help them make those adjustments such as: portable pensions, child-care services, and force, additional knowledge. There is a whole array of issues there.

THE EXTERNAL AGENDA

At the same time, there is the question of the United States constructing a different form of external agenda. And I believe at the heart of that external agenda is—obviously, the need to deal with issues such as exchange rates, better cooperation with the major industrial nations, and better management the Third World Debt—but I think at the heart of a new approach has to be a recognition of the differences in economic systems that now exist in the world.

Our present global trading system was essentially put into place between 1943 and 1947. It was put into place by the English and by the Americans and by the Canadians. They put that system into place largely around an Anglo-American economic model. And, for the time when it was put into place, that was very appropriate. That type of economic system had a quarter of the world's population; it had more than 60 percent of global industrial production.

It was designed essentially around a rule-driven market economy—in other words, government sets the rules, and within those rules, entrepreneurs and businesspeople can do whatever is necessary to produce.

And it is a system that has worked very well, at least, that type of economy, for the United States. It does produce the goods and services.

TYPES OF WORLD ECONOMIC SYSTEMS

But what has happened over the years is that four other types of economic systems have come into play, and now do a major part of the global economic activity.

There are the command economies such as the Soviet Union's, which altogether do about 20 percent of the global economic activities, and they do a large part of that through barter. Coca-Cola will send syrup into Eastern Europe, will take wines in exchange, and bring them back to the United States and sell them.

There are the mixed economies such as in Sweden and France.

There are the developing economies in other parts of the world. There are also the Canadian, the British, and the Australian economies, which are essentially like our economy.

PLAN-DRIVEN MARKET ECONOMIES OF ASIA

And then, you have the plan-driven market economies of Asia. They are a very dynamic form of economic system, where business and Government will work together, where within the context of some shared visions of the future, certain industries at least are favored, if not targeted. Their research is focused toward those favored industries. There is infant industry protection. Special attention is given to exports. Once an industry is able to be competitive in terms of price, service, quality, innovation and marketing, they will surge into the global market with experts.

TRADING PARTNERS POLICIES MUST BE COMPATIBLE

What I am suggesting is that we have really come to a point where these distinctions need to be recognized as we structure our trade relationships. With nations that have in effect free market, rule-driven economies such as Canada, we should engage in free market negotiations, with other nations that have command economies, we should have another strategy that deals with that type of economy. And then in between, such as the plan-driven market economies, we need again a different type of economic relationship.

What I am suggesting is one type of policy, one type of strategy is simply no longer appropriate in dealing with the various nations with which we deal.

Now, within that context, and I think if we will make that kind of recognition, much of the debate on trade can move away from issues such as free trade or fair trade or protectionism. Those issues are appropriate, for example, when we are dealing with the Canadians. I think they really do not have a great relevance, however, when we are dealing with the People's Republic of China or when we are dealing with Japan or Korea or other nations.

At the point that we make those distinctions, it also seems imperative that we address a series of other issues—questions such as technological reciprocity; issues such as the application of our antitrust laws in the United States to foreign firms as they invest and deal within this nation; the question of exchange of students, and what are our objectives in each of these areas.

Senator DOMENICI. Mr. Chairman, excuse me.

Chairman CHILES. Yes.

Senator DOMENICI. Where did you put Japan as you went through those different kinds? I thought you put it in something other than like ours.

Dr. CHOATE. I categorized it, and I think others do as well, as a plan-driven market economy. There the power of the State and the flexibility of the market are merged.

In essence, I am saying that we have all of the strengths necessary to meet the competitive challenge. Our firms can produce goods and services that are competitive in terms of the five fundamentals—price, quality, service, innovation, and marketing. But if the Harvard Business Review is correct that about half of the decisions of business are influenced by government, then the decisions of government are important because they set the environment in which American business and workers will take on these challenges.

At present, there are a number of obstacles or choke points that keep our workers and our businesses from meeting these challenges. The issue, then, is largely one of identifying those obstacles, several of which I mentioned, and eliminating them.

Thank you.

Chairman CHILES. Thank you.

[The prepared statement of Dr. Choate follows:]

Statement

of

Pat Choate
Director of Policy Analysis
TRW Inc.

Before

The Senate Budget Committee

United States Senate
One-Hundredth Congress
February 26, 1987
Washington, D.C.

Mr. Chairman and Members of the Committee:

I am honored and pleased to have this opportunity to share with you some thoughts on trade and competitiveness. And in fairness to you and my employer, TRW Inc., I emphasize that the views I offer do not necessarily represent any position other than my own.

ECONOMIC INERTIA

In many ways, the U.S. economy can be compared to a large airplane that works very well when it moves at a brisk pace but becomes unstable, even dangerous, when it slows.

Over the past two decades, the U.S. economy has slowed and become unstable and, if not dangerous, at least unable to meet many of our national aspirations. Specifically, real GNP growth has been sluggish; industrial investment and productivity are in decline; the United States has, with surprising swiftness, become the world's largest debtor; and American industry is fast losing ground in one sector after another -- basic, high-tech, business services and, most recently, agriculture.

This decline has been long in the making. It continues unabated even though the United State still possesses an enormous capital base, the world's best scientific establishment, millions of highly trained and productive workers, and unimpeded access to the world's largest market, our own.

The central economic question is what must we do to reverse the trends of recent years and deploy our formidable assets to meet the far-reaching and quick shifts now underway in global competition, technology and demography.

TWO INTERDEPENDENT AGENDAS

Two interdependent agendas of action are required to meet this challenge: one internal agenda and the other external.

An Internal Agenda

The internal agenda would focus on producing goods and services that are competitive in terms of price, quality, service, innovation and marketing. This agenda would require changes in both macroeconomic and microeconomic policies.

Among the more important of the macroeconomic measures is the need to reduce the federal budget deficit -- for the nation to pay for its publicly financed consumption and investment now rather than later. Equally important, fiscal and monetary policies need be better harmonized and the exchange rate of the dollar closely monitored and managed. These macroeconomic actions would correct at least half of what ails the U.S. economy.

While improved macroeconomic policies are a necessary condition for improving the nation's economic performance and competitiveness, however, they are an insufficient condition.

Special attention is also required to the dozens of powerful microeconomic interventions that influence both the overall functioning of the economy and the vitality of specific industries. These microeconomic interventions include policies and programs in areas such as education and training, natural resources, strategic materials, government credit, research and development, infrastructure, regulation and public health, among many others.

Among the microecnomic interventions that merit special attention are those that allow financial institutions to pressure business for short-term performance at the expense of long-term competitive position; the inability to furnish displaced workers with the job information, counseling, testing and training they need to get back to work; the lack of portable, personal pensions that are tied to the worker rather than the job; the absence of safe, affordable child-care services for working parents; and the need for a tax code that will encourage the creation of share compensation systems that can better link work and rewards.

Attention to macro- and microeconomic interventions can do much to create an economic environment in which firms can innovate, invest, and market goods and services that are fully competitive; and in which workers can secure training, find jobs, be productive, and shift between jobs and occupations with ease and confidence.

An External Agenda

At the same time, the United States requires an external competitiveness agenda. Such an agenda must be guided by the recognition that the nation's economic interests are as critical to its well-being as its defense and foreign policy interests.

The objective of such an agenda would be to create stable and pragmatic relations with foreign economic systems that are very different from our own, and to do so not by punishing other nations for their success or reversing their economic progress, but by increasing America's capacity to compete.

The nation requires a major review of its global economic policies, particularly its trade policies, for they remain trapped in a time warp of the 1940s, when Britain and the United States dominated the global economy, tariffs were the principal barrier to trade, and U.S. supremacy was uncontested in virtually all industries.

Today, more than three-quarters of world trade is conducted by economic systems very different from our own, a growing array of barriers distort global trade flows, more than 70% of U.S. goods and services face stiff foreign competion, and the principal international treaty on trade -- the GATT -- now covers less than 7% of world imports, exports and capital flows.

Despite the urgent need to modernize its policies, the United States lacks the flexibility to do so, paralyzed by the unrelenting conflict between "free" and "fair" trade. Yet the principal issue that U.S. trade policy must face is not free trade (which no longer really exists) or fair trade -- or even protectionism.

It is market access -- the extent to which other nations will accept U.S. goods, services and investment, and under what conditions.

Equally significant, the longstanding U.S. position that a multilateral world requires multilateral negotiations has become dangerous, for it misses numerous opportunities for cooperation.

To prosper in today's global marketplace, the U.S. requires a trade strategy that is both less ideological and more practical. The two requisites of such an approach are a practical means for opening or closing U.S. markets to specific nations in direct relation to American access to theirs, and a flexible negotiating strategy for parallel trade talks with one, several, or all nations.

To create such a strategy, the U.S. must overcome a formidable barrier to flexible trade policymaking: our inability to discern the subtle differences between U.S. and foreign competitive practices.

Five Different Types of Competitors -- U.S. workers and firms face competition from five types of economic systems: Centrally planned (such as the Soviet Union); mixed (France); developing (Brazil); plan-driven (Japan); and rule-driven (Canada and U.S.). And while the global trading system is still modeled on the Anglo-American rule-driven economy, the other systems now account for more than 75% of all world trade.

In the rule-driven economies, government sets the economic backdrop but takes no direct position on which industries should exist or grow. By contrast, plan-driven economies such as Japan's skillfully blend the strength of the state with the flexibility of the market. They are directed by politicians and business leaders whose concern is to improve national prosperity by advancing and shaping their own specific industries.

The overarching economic objective in plan-driven nations is to export, and commerce is dominated by huge conglomerates. Japan's Mitsubishi's 1983 sales, for example, exceeded the combined revenues of IBM, AT&T, IT&T, Chrysler, U.S. Steel and Xerox. If a company in an industry group needs to buy a product, the affiliated firm that produces the item generally has first priority for the sale, a foreign firm the last. Workers, capital, technology and expertise are shifted between member companies within each group, improving the capacity of all to adjust to changes in production or to movement into more advanced industries.

In all such economies, business and government jointly establish economic objectives. In Japan, consumer electronics was the target industry in the 1960s, autos in the 1970s, and high-tech goods in the 1980s. In the initial stages of a plan the government closes or sharply restricts domestic markets to provide a safe harbor for the developing industry. Public and private resources are focused on the development of technical expertise.

The effort becomes a prestigious national enterprise, much as going to the moon was for the United States. Once an industry has achieved world-class competitiveness, government and business work toward major export drives. To trade with the plan-directed economies requires negotiations with business and government as well, particularly if that trade involves imports of competitive goods that have been targeted as a national priority.

The mixed economies, such as that in France, are based on a combination of state and private ownership, market and nonmarket decisions. The major industries there are tightly regulated or actually owned, wholly or in part, by the government.

In centrally planned economies -- China, the Soviet Union -- markets are irrelevant, and trade is conducted solely with the government.

Finally, the economic systems of developing nations have borrowed from each of the other four systems. A growing number are adopting the techniques that have brought success to the plan-directed market economy of Japan. In most, government plays a key role in trade negotiations.

Eclipsed -- Both the rule- and plan-driven economies are efficient and work well domestically. In trade competition, however, the results-oriented, plan-driven economies have consistently eclipsed the process-oriented, rule-driven economies in their ability to define national interests, establish joint business-government efforts, and shape and ultimately dominate markets.

Because U.S. officials have been so devoted to free trade as a national strategy, they have failed to consider the often vast differences between foreign and domestic competitive practices. Consequently, American trade policies have fallen out of step with those of other countries, causing serious and widespread harm. Industries facing predatory foreign competitors have been unable to get relief. Long-term consumer interests have been sacrificed. Reciprocal market access has been discredited as a negotiating strategy. And tough negotiating tactics have been mistaken for "bashing" other nations.

A U.S. industry that petitions for relief from illegal foreign trade practices typically faces a hostile Washington that considers the industry guilty of being uncompetitive. U.S. policymakers are unable -- and more important, unwilling -- to distinguish inefficient industries from those that really face unfair competition.

In the belief that unconditional access to foreign products is in the best interests of American consumers, the U.S. keeps its markets open to the exports and investments of companies of many nations that close their markets to American competitors. Such a policy ignores several important realities: the global scope of most markets; the monopolies that many foreign governments and companies are attempting to create; and the rapaciousness of foreign monopolists which often exceeds that of the 19th century robber barons.

The reality of global trade is that other nations have large, wealthy markets. Despite repeated attempts to open many of these markets, they often remain tightly closed to many of America's most competitive products.

Direct and subtle restraints are erected. They include tariffs and import charges; quantitative restrictions; import licensing; customs valuation; standards, testing, labeling and certification; government procurement restrictions; export subsidies; intellectual property-related obstacles; countertrade and offset requisites; service barriers; and investment barriers. Often American firms face a combination of these obstacles. The net effect is a substantial reduction in U.S. exports and foreign investment.

If other nations remain unwilling to take effective -- not simply cosmetic -- steps to remove these barriers and open their markets, then tough American responses are inevitable.

Negotiation

Distinctions about the different types of economic systems are essential to any larger effort to form a coherent and effective trade strategy.

The most important consequence of recognizing these differences would be the formulation of a U.S. trade negotiation strategy that would negotiate free trade agreements with nations that practice free trade, managed trade agreements with nations that practice managed trade, and subtle variations for economic systems that fall between these two extremes.

A pragmatic U.S. trade negotiation strategy is essential since the next round of negotiations will be the most important since World War II -- and the most political. If the United States will pursue a more flexible, less ideological trade strategy, it has a better chance of resolving some of the more pressing trade issues.

Since any substantive trade agreement is likely to require congressional approval, a means for including Congress in the negotiations should be developed before the talks begin. Congressional involvement -- perhaps through the formation of a joint committee, as was done with energy legislation in the 1970s -- will speed the negotiating process and lend support for whatever agreement emerges. Most important, Congress must urge the Administration to focus on reciprocal market access and parallel trade talks.

In the future, as in the past, America's principal tool for negotiating the opening of foreign markets is to regulate access to its own. If the United States is unwilling to secure its borders as a means of negotiating the opening of other borders, then there are no other means available to induce other nations to unbar their markets to American goods, services and investment. Hard-nosed, results-oriented negotiations centered on reciprocal access to markets is the best, if not the only, negotiating chip the nation possesses.

Congress should also insist that the Administration pursue a parallel negotiation strategy, holding concurrent discussions with any nation or group of nations that is willing to talk. This would demonstrate that the U.S. will negotiate long-term agreements with cooperative trading partners, whether other nations participate or not. In itself, this is a formidable incentive for uncooperative nations to end their delaying tactics.

Ideally, these trade talks would proceed bilaterally (with one other nation); plurilaterally (with several nations); and multilaterally (with many nations). Within each of these negotiations there are a number of issues that warrant special attention.

Bilateral Negotiations -- Many of the most pressing trade issues can be addressed in bilateral talks.

The United States is already engaged in bilateral free trade talks with Canada. These talks enable us to address issues such as the 1985 Auto Pact's and its enormous loopholes, which permit foreign firms to export massive numbers of motor vehicles to the United States.

The most critical bilateral issues, however, concern trade with plan-driven market economies -- Japan, South Korea, Taiwan and Singapore.

It is imperative that the U.S. confront the trade surpluses of these nations because they are not only the principal source of U.S. trade deficits but also America's main economic competitors, models for the economic policies of other nations, and the most secure U.S. allies in the Pacific. Together, they represent the second-largest market in the world. Firms in the U.S. cannot operate successfully in the global marketplace if they are unable to penetrate that market while firms in those nations enjoy unrestricted access to the American market.

Negotiations must focus on two basic issues: the opening of markets, and the market shares that will be permitted. U.S. pressure has already forced Japan, South Korea, Singapore and Taiwan to lower many tariffs and quotas, but nontariff barriers still exclude most U.S. products. These nations have justified their protectionism by citing the poor quality of U.S. products, the high cost of U.S. labor, an overvalued dollar, and the failure of U.S. firms to understand local markets. These rationales ignore the steadfast refusal of these countries to accept many reliable, innovative, competitively priced U.S. products, such as satellite equipment and pharmaceuticals.

When forced to open their markets, the Japanese have responded by making minimal concessions and then building assembly operations in the protesting nation. Thus, the Japanese, when confronted with restrictions on their VCR exports to France, constructed a VCR production facility in that nation and are now building auto assembly operations in the U.S. These investments have several trade-related advantages for them. For one, they permit the Japanese to avoid import quotas. Since the operations often involve little more than the assembly of Japanese-made kits, the profits and best jobs remain in Japan. Most important, existing U.S. law allows them to underprice their U.S.-produced goods in America to capture market share and avoid fines.

Permitting such branch-plant investment to continue unregulated is sure to convert the U.S. into a locale for low-value-added, low-wage work assembling parts designed and manufactured elsewhere. Successful bilateral negotiations with the plan-driven economies of countries such as Japan must deal with trade in its totality -- imports, exports, levels of trade and types of investment.

Other issues merit exploration in these talks. One is U.S. antitrust treatment of foreign investment. Specifically, many foreign competitors appear to be engaged in economic practices that are prohibited to American firms. The role of banks in their economic combines, the extent of their vertical and horizontal integration, and their past dumping practices all raise thorny questions about the standards to which foreign firms should be held now that they are operating within the United States.

Equally important, we need to negotiate reciprocity in technological exchanges between the United States and other nations. Such negotiations with Japan are particularly important since Japanese firms are the principal technological competitors of U.S. firms.

Today, Japanese firms have almost unimpeded access to U.S. science and technology. U.S. firms and scholars have far less access in Japan. A number of steps to increase this reciprocity are required, such as expanding the translation capacity of the National Technical Information Service and monitoring student and technological exchanges.

Plurilateral Talks -- Negotiations involving several nations can be structured so that agreements can be integrated into a broader round of multilateral treaties later on. Since the countries involved will feel compelled to participate to protect their own interests, such negotiations may be an effective stimulus to multilateral discussions.

A number of issues, including the rising debt of developing nations and the need for industrial nations to find ways and means to better protect their intellectual property rights, now warrant special attention.

Multilateral Negotiations -- Multilateral talks are needed as a longer-term means to open global markets and confront issues such as the lagging development of many nations.

CONCLUSION

In sum, the United States has neglected the need to compete. We are now paying the price in terms of slower growth, lost markets and real threats to our longer-term prosperity.

Yet the inertia of the past need not continue. The nation is still a powerful competitor. We have the resources and the knowhow needed to regain the momentum we once possessed. What is required now are dozens of practical actions, taken by business, workers, unions, education and government. I sense that the nation has arrived at a point where it is willing to identify those steps and take the needed actions.

Thank you.

Chairman CHILES. Dr. Holland? We introduced you a little earlier, and we are delighted to have you, as the president of the Committee for Economic Development, and we will be happy to hear your statement now.

STATEMENT OF DR. ROBERT C. HOLLAND, PRESIDENT, COMMITTEE FOR ECONOMIC DEVELOPMENT

Dr. HOLLAND. Thank you, Mr. Chairman.

I am glad to be here. I am sorry I was not here from the outset. I am going to give a speech about having a more adaptable economy, and I would have liked to have been demonstrated a little more adaptability myself. But I will straighten out those glitches, and give you a clean copy of my statement for the record.[1]

Chairman CHILES. Fine.

Dr. HOLLAND. I am glad to be with you. I hope I can say some things that might be of help to you.

Senator WIRTH. Mr. Holland, maybe you could "adapt" the microphone a little more. Thank you.

Dr. HOLLAND. I am particularly pleased you chose to include in this Budget Committee hearing the critical issue of the relationship between the U.S. Federal budget deficits and the trade deficit; the current state of U.S. competitiveness; and the impact that competitive change is having on the health and well-being of our labor force. I am also pleased to see attention to the important role that education plays in fostering our international competitiveness.

CED has recently completed or is in the process of developing indepth policy statements on all of these subjects. I believe we have put in front of you copies of our documents on three of these subjects, particularly on education, on work and change, and on the twin deficits and our integrated view of them. I will draw upon those in the rest of my statement.

First, if I may, let me call your attention to the paper that I believe each of you have a copy of, titled, "An Integrated View of U.S. Budget and Trade Deficits and What to do about Them." If you will turn past the first few pages, you will hit a sequence of five charts, and I am going to use those charts to make my points.[2]

This is a draft document, still in process of finalization, but it seems so apt for the purposes of this committee that I wanted to bring it to you.

DEFICIT MAJOR CAUSE OF TRADE DETERIORATION

As chart No. 1 shows, the dramatic deterioration of the U.S. trade and current account balances started really in 1981. We had been seesawing and softening a little bit before, but then in 1981 the pace of decline became much sharper.

The resulting damage to U.S. economic objectives and interests is summarized in the following chart 2—depressing and dislocating trade-sensitive industry all over the United States, curtailing U.S. job growth, reducing incomes of U.S. workers, particularly those laid off or experiencing cutbacks, according foreign producers strengthened market positions and building up foreign debts for future generations of Americans to bear.

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[1] See p. 330.

[2] See p. 344.

The principal factors contributing to this sharp loss of U.S. competitiveness in the past 5 years, as demonstrated by the very sharp drop in the trade deficit, and the remedial steps likely to prove most effective in the coming 5 years in turning that around, we summarize on charts 3 and 4.

The main finding that it jumps out at you from those charts, as jumped out at us from all the review we did of empirical and anecdotal evidence, is that by far the largest factor underlying the deterioration of the U.S. trade position since 1981 has been the enormous increase in U.S. budget deficits.

These large deficits, through the complex interactions that are described in the text of this paper, have in turn been of key importance in the sharp average elevation of the foreign exchange value of the dollar against the currencies of many major U.S. trading partners. And that resulting price handicap imposed on U.S. producers has been a major factor holding down U.S. exports and boosting U.S. imports during these years.

Other longer term competitive forces have also been at work during this interval, as itemized there on charts 3 and 4. But as we assay the evidence, they do not account for all that much of the abrupt deterioration in the U.S. trade balance in this 5-year span. In fact, such measures as U.S. manufacturing productivity and wage trends relative to those abroad, were less unfavorable over the years 1981–86 than in the preceding 5-year period.

Past developments, of course, do not necessarily provide a complete guide to the steps needed to be taken to improve U.S. competitiveness in the future. We believe, however, that significant and sustained reductions in U.S. budget deficits will be of key importance for such an improvement, particularly in the years immediately ahead.

CONGRESS MUST PROVIDE HEALTHY ENVIRONMENT

This brings me to the important leadership of your committee. As we see it, you have a major role to play in providing U.S. managers and workers with a fiscal and economic environment in which vigorous and well-aimed competitive efforts on their part can succeed. They have to make those vigorous and well-trained efforts, but you need to give them the environment in which those can produce most competitive fruit.

Now, it must be remembered that fundamentally, our country's living standards benefit most from the extent to which we can achieve gains in U.S. industrial competitiveness through increased productivity and efficiency. But these take a much longer period than 5 years before they can cumulate to major positive results.

EDUCATION, TRAINING, AND R&D

Productivity, of course, is an area for which business and labor bear the major responsibility. In the long run, however, U.S. international competitiveness also calls for supportive improvements in basic education, in training and in scientific research, areas in which strengthened and more efficient cooperative efforts by Government and the private sector can make major contributions.

The chart presentation I have called to your attention is focused on the next 5 years. But we are aware that the long run exists, also, and it starts now. Thus, basic improvement in U.S. competitiveness calls for timely initiation of a comprehensive program of measures for which the full payoff may still be a good many years away.

Our paper summarizes needed improvements in both the near term and over the longer term. Two areas needing long-term improvement have been of special concern to CED and perhaps to you, also—education, and the ability of workers to adapt to these marked changes in international competitiveness.

Let me use most of the rest of my time to comment about CED views on the most important actions needed in these two areas.

MANUFACTURING IN BOTH GROWTH AND DECLINE

Our studies and experience convince us that the U.S. manufacturing sector and its employment is undergoing both growth and decline. It is not in permanent descent across the whole board, but what good news there is is by no means universal, either. Some industries are experiencing an increase in both jobs and output, and have done so for much of the past 15 years. Others have made significant advances in output, but with fewer people, with a lot of productivity gain. And one has to say that some important sectors of industry have also really taken it on the chin, and so have their employees.

Added together, the manufacturing sector continues to provide about as much to GNP, as a percent of GNP, as it has since about 1950, setting aside cyclical fluctuations. But U.S. manufacturing in total has not been a source of net new permanent employment opportunity for about two decades now, again setting apart cyclical fluctuations.

We need to be aware of this highly variegated experience taking place inside American manufacturing. It is not a monolith. The more attention we can give to that variability, the more we can obtain clues about what it takes to improve the areas where we are performing the worst and where we have advantages to make the most of.

Attention to that variegated detail can also give us a more accurate picture of why some displaced workers succeed in rapidly finding new jobs that pay close to their old ones, while others in similar jobs and in the same industries experience considerable difficulty. Many are suffering hardship; many are not.

SERVICE JOBS HAVE BEEN LOST TOO

We are impressed, for example, in looking at the data, by the fact that about as many dislocated workers have lost their jobs in service occupations as have lost them in manufacturing. We count the total number suffering hardship from job loss at significantly less than 1 million. By our standard, those requiring special attention number about one-half of 1 percent of our labor force. That is a big enough number to be very concerned about, but I think small enough not to call for a major-gangbusters Government program.

A key question is: What job opportunities are there for these people to move into, and how worthwhile are they?

I expect manufacturing itself will continue to create about as many new job opportunities as it is eliminating—but that means net; it is making no net contribution. Much of the net new job growth and opportunity will continue to be found in services. And it has become a commonplace number to cite that we added 21 million new jobs in the last 11 years, and most of those net were in services—almost all of it.

NEW SERVICE JOBS NOT LOW PAYING

But it is inaccurate to view those jobs as on the average poorer-paying replacements and less worthwhile than the manufacturing jobs being lost. In fact, according to BLS, the fastest growth across-the-board is occurring in those service jobs requiring higher-order skills, more professional, managerial and technical competence.

We deduce from this that public and private policy should take as a fundamental objective to better enable workers to take advantage of new and better job opportunities, not only after they lose jobs, but even while they are being employed, before job loss threatens.

This adds up to some important changes, we think, in the policy and the posture of government, labor leaders and business management in these circumstances. We think it takes a fundamental reassessment of the tradeoffs necessary to assure the competitive success of a business unit and the rewards that will be necessary in terms of pay and employment security for workers who are going at times to have to make painful adjustments.

PRIVATE SECTOR ACTIONS TO IMPROVE COMPETITIVENESS

For the private sector, we think this boils down to three essentials. First, much more open communication, where firms provide employees with enough information for those employees to understand their role and their unit's role in the competitive success of the enterprise. This requires a major change in many corporate practices, although we see gratifying changes of this kind taking place that we believe can be spread more broadly through American industry with the right kind of push.

Secondly, with that kind of better communication providing the basis for more mutual trust, both workers and employers need to move away from traditional patterns of rigid compensation to a more flexible system where a part of workers' compensation is based on the competitive results of the business unit.

A third area involves a fundamental reworking of employee benefits to enable, for example, severance pay, health benefits and pensions to be adjusted so as to be more conducive to employment adjustment and not a hindrance to employer mobility.

Finally, we think corporations need to prepare workers more in advance for all decisions that will permanently affect that worker's employment conditions. We believe this can and should be done in a voluntary manner. Companies need to provide more training and retraining, designed to enable workers to move to new work both inside and outside the company.

PUBLIC SECTOR CHANGES TO IMPROVE COMPETITIVENESS

We also see counterpart changes enabling changes in public policy. We see a need to redesign unemployment insurance so it can provide greater incentive for faster work transition, and administrative redesign of the dislocated worker program under Title III of the Job Training Partnership Act to make it a more effective and more responsive resource for workers who are affected by plant closings and the like.

With specific regard to the administration's $900 million dislocated worker proposal that has now come up to the Hill, while we are concerned about its net $500 million-plus deepening of the deficit, we see the gains to the economy from that kind of program and I believe my own CED trustees would support it in principle provided it meets our test of effective transition assistance.

EDUCATION BIG FACTOR IN JOBSEEKING

Our final area of concern is education. Here, I want to focus particularly at the primary, secondary and preschool levels. We found in our study of dislocated workers that the extent to which there was a level of secondary education attained by the worker was a key determining factor in the person's ability to move rapidly to new work.

We believe that same condition will hold true in the general economy. In our study on education that we called, "Investing in our Children," we found compelling evidence that schools have not been adequately preparing new jobseekers to meet the changing nature of jobs in the economy.

The analysis we did with a survey across a large cross-section of employers said that the chief skills most needed for employability at the entry level are: Learning how to learn, articulate and effective communication both ways, good personal and disciplinary habits, and a strong sense of responsibility not only to the person's job but also to their fellow workers and their role as citizens.

And we found these kinds of entry level requirements to be generally true not only among large businesses, but also among smaller firms and nonprofit organizations.

We think changes need to be made to go about preparing our youth better in our educational system. We think we cannot afford, socially and in terms of the human loss of resources, the nearly 800,000 American students who each year do not finish school. Even more students graduate from school but still are not proficiently equipped with skills to meet the jobs of the future.

We do believe there will be jobs in the future. The kids need to be prepared to fill them effectively.

PRESCHOOL PLACE FOR EDUCATION DOLLAR

Our study presents a number of carefully researched recommendations for how to improve schools—how to get more for our tax dollars, in effect. I will not detail them all here, but I will tell you the one that surprised us the most.

We found evidence that persuaded us that the best single place to spend another dollar in schools—the place to get the biggest bang for one more buck spent on public school systems—was to spend it on good preschool programming, particularly for the educationally disadvantaged.

We were not expecting that, but we have been persuaded, and we are now strong advocates of that very kind of programming.

We are doing more analysis particularly of the educationally disadvantaged, and will bring another report out, I hope by midsummer, on that subject.

LIMITED FEDERAL ROLE IN EDUCATION

When it comes to Federal Government support of education, we believe it should have a relatively small role, except in the important areas of research, program experimentation, and preschool education.

We think basically public education should be paid for at the State and local level, for all kinds of reasons.

WHO PAYS FOR THE DISADVANTAGED AND HANDICAPPED

Chairman **Chiles**. What about disadvantaged and handicapped students?

Dr. **Holland**. We think most school systems can handle that one, too. But we admit that is one of the areas where——

Chairman **Chiles**. It did not. They did not.

Dr. **Holland**. Many have not, that is true. I think in too many places, Mr. Chairman, it has been regarded as essentially a charitable or add-on activity.

I think when you look at the preschool education results and recognize that its cost is not an expense but an investment, it becomes very clear that it is in the school districts' and in the States' own interests to fund more of that kind of programming.

That is a message that needs to be spread around. I agree with you it has not thus far. But I believe it is spreading. We are trying to spread it. I know other administrators in the school system are as well, and I believe you will find it will spread rapidly.

I agree if you find areas where that enlightened understanding will not take root, and the thing that is holding preschool back is lack of funding, there is a case for coming back to the Federal fisc. But I think there will be very few of those kinds of areas.

When you look at how worthwhile preschool is to the State and local community and also, when you remember there is a record that those areas tend to spend dollars most effectively and to watch over them best when they are their dollars——

Chairman **Chiles**. That is right, but the Federal role has never been that we are going to pay for all of this. The Federal role has been that we are going to be the trigger, put the seed money in and require the States to have to do this.

Dr. **Holland**. Ah—then, Mr. Chairman, you and I are in much closer agreement than we first thought, because when I said there was a Federal role, I said it was relatively small except in areas of research, program experimentation and preschool education. And

Federal support in those specific areas, particularly preschools, I regard as very important.

Chairman CHILES. I would like to see your study go a little further to disadvantaged students.

Dr. HOLLAND. The educationally disadvantaged study we will bring out may well do that. I cannot say it will yet, until we vote on it.

Chairman CHILES. I will look forward to that study, because I think that might startle and surprise you similar to your preschool findings.

Dr. HOLLAND. We do not believe we know everything. We have learned we have to change our minds as we study some of these matters, and we have indeed done so already, as you can tell from some of the things I am saying here.

PAYING THE FOREIGN DEBT

I should not close my testimony, Mr. Chairman, without harking back one more time to the urgency for remedial action in the macroeconomic area. Even if we achieve the longer run improvements we have been talking here about in education, productivity and other areas, and those actions help to accomplish a gradual shift from these very deep U.S. trade deficits to a substantial U.S. trade surplus, say, within the next 5 to 10 years, we still are going to have a problem. The huge level of foreign debt we have built up as individuals, businesses, and the Government, we will continue to have to service.

The final chart in that booklet I call to your attention, chart 5, shows the buildup of our foreign trade debt. It shows what it has been in the past and what it would look like even if we turned around our trade deficit right now. From a surplus of over $100 billion as a net foreign creditor as recently as the end of 1982, at the rate we are going, the United States is going to have an estimated $750 billion in net international debt by 1990. In effect what we have been doing is borrowing to live beyond our means—well beyond our means.

A painful byproduct of building up such debt is the increasing cost of servicing that debt. Even to pay the net interest due on these accumulating net totals of foreign obligations, the United States is going to have to produce more than it consumes domestically and export more than its imports for some years to come. Until we reestablish that kind of trade surplus, the build-up of our net foreign debt cannot be turned around.

The worst part of this is that the money for servicing and ultimately reducing that accumulated foreign debt of this country will come out of the pockets of Americans in the form of declines in their potential future standard of living. That hurts.

Thank you.

Chairman CHILES. Thank you, sir.

[The prepared statement of Dr. Holland follows:]

TESTIMONY

of

Robert C. Holland
President
Committee for Economic Development

THE INTERRELATIONSHIP BETWEEN THE FEDERAL BUDGET and TRADE DEFICITS

before

SENATE COMMITTEE ON BUDGET

Thursday, February 26, 1987

MR. CHAIRMAN, my name is Robert C. Holland and I am President of the Committee for Economic Development. As I believe you know, CED is an economic policy research organization that directly involves 220 of our nation's top business and education leaders. CED's primary focus is to work for economic policy at all levels of government that is conducive to stable, long-term economic growth and an improved standard of living for all Americans.

I am particularly pleased that you have chosen to include on your hearing agenda the critical issue of the relationship between the U.S. federal budget deficits and the U.S. trade deficit; the current state of U.S. competitiveness; and the impact that competitive change is having on the health and well being of our labor force. I am also pleased that you are addressing the important role of education in promoting international competitiveness.

CED has recently completed or is the process of developing extensive policy statements on all three subjects. We are investigating the critical interrelationship between fiscal trade and competitiveness issues and especially the subcommittee chaired by Charles Parry, Chairman and CEO of Aluminum Company of America, their findings and evaluations to date are summarized in the draft document, **"An Integrated View of U.S. Budget and Trade Deficits"**.

On the subject of the impact of changing international competitiveness on U.S. employment, we have just completed a major in-depth study, Work and Change: Labor Market Adjustment Policies in a Competitive World, headed up by Frank Doyle of General Electric Company, who I consider to be one of the country's leading business experts in this field. Frank has also served on Secretary of Labor Bill Brock's Task Force on Dislocated Workers.

In the area of quality education, we are engaged in a country-wide major series of discussions of our findings and extensive recommendations on how to improve our nation's public elementary and secondary schools as set forth in our policy study, Investing in our Children: Business and the Public Schools. This study, which was developed under the determined leadership of Owen B. Butler, recently retired Chairman of Procter & Gamble Company, communicated the results of two years extensive analysis and research on both corporate skill requirements for students graduating from high schools and the extent to which they are meeting these tests and providing the skills needed in today's changing work place. The paper also analyzed in a very detailed and specific fashion the returns on investment on various kinds of resource allocation which we are convinced can make a major contribution to improving the graduating students' work skills both now and in the long-run. Brad is also chairing the follow-up study on the specific problems of the educationally disadvantaged, which we bring before our Policy Committee in May and hope to make available as soon as possible thereafter.

For both of these studies, I will comment more specifically on their relevance to competitiveness, some of their specific research findings, and highlight their major recommendations.

I believe the Committee has been provided material from all three projects. Before commenting upon CED's findings and briefly summarizing the recommendations contained in **"An Integrated View of U.S. Budget and Trade Deficits"**, which I believe you have before you, I believe my testimony would be more pointed, if I now refer to the series of charts found in the first few pages of the document.

As chart 1 shows, the dramatic deterioration in the U.S. trade and current account balances started only in 1981. The resulting damage to U.S. economic objectives and interest is summarized in the following chart 2 -- depressing and dislocating trade in sensitive industry, curtailing U.S. job growth, reducing income of American workers, particularly those who had been laid off or experienced cut-backs, according foreign producers strength in market positions and building up foreign debts for future generations of Americans to bear.

The principle factors contributing to the sharp loss of U.S. competitiveness in the past five years and the remedial steps likely to prove most effective in the coming five years is summarized in charts 3 & 4, which summarizes our conclusions. Our main finding is that by far the largest factor underlying the deterioration of the U.S. trade position since 1981 has been the been the enormous increase in the U.S. federal budget deficits. These large budget deficits, through the complex interaction that is described in the text of this paper, has in turn and of key importance in the sharp average elevation of the foreign exchange value of the dollar against the currencies of many U.S. major trading partners. The resulting price handicap imposed on U.S. producers has been a major factor holding down U.S. exports and boosting U.S. imports during these years.

Other longer-term competitive forces were also at work, but they do not account for much of the abrupt deterioration in the U.S. trade balance in this five year span. In fact, U.S. manufacturing productivity and wage trends relative to those abroad where less unfavorable over the years 1981-1986, than in the preceding five year period.

Past developments, of course, do not necessarily provide a complete guide/to the steps needed to be taken to improve U.S. international competitiveness in the future. We believe, however, that significant and sustained reductions in the U.S. budget deficit will be of key importance of such an improvement, particularly in the immediate years ahead. This brings me to the important leadership of your Committee. You have a major role to play in providing U.S. managers and workers an international economic environment in which vigorous and well aimed competitive efforts on these points can succeed.

It must be remember that, fundamentally, our country's living standard will benefit most from the extent to which gains in U.S. international competitiveness can be achieved through increased productivity and efficiency, but these take a longer period than five years before they build up accumulatively substantial positive results. Productivity, of course, is an area for which business and labor bear a major responsibility. In the long run, moreover, U.S. international competitiveness calls for basic improvements in education, training, and scientific research -- areas in which strengthened and more efficient cooperative efforts by government and the private sector can make a major contribution.

Although our chart presentation is focused on the next five years, we are accutely aware that the long run starts now and that basic improvements in U.S. competitiveness call for timely initiation of a comprehensive program of measures for which full pay-off may still be a good many years away. Our paper summarizes reform in key areas for improvements in both near term and over the longer term. I trust that the analysis which we have provided in this document about both causes and cures of the competitiveness problem can be of help to policy makers in their difficult task.

Two areas needing long-run improvement have been, as I have indicated of special concern to CED and, perhaps to you also -- education and the adaptability of workers to these market changes in international competitiveness. Let me use the balance of my time to highlight some of our research findings and our analysis of these findings as it pertains to the changing structure of and to the extent to which our schools are contributing today and will contribute in the future to the employment needs of the economy. I will also briefly summarize what CED views as the most important action needed in these two area. I will also comment on their implications for the federal budget picture.

Beginning with our recent paper, Work and Change: Labor Market Adjustment Policies in a Competitive World, we first found a popular impression that American manufacturing as a whole is in a permanent state of decline is wrong, and represents a dangerous overgeneralization of what is actually occurring. Nor is employment an accurate reflection of where and what industrial sectors manufacturing is in a state of decline. In reality the manufacturing sector and employment is undergoing both growth and decline. Some industries in other words are experiencing an increase in both jobs and output, and have done so for much of the past fifteen years. Still other industries have been making significant advances in output but have done so with fewer people, indicating rapid increase in productivity and technological change. In general, the manufacturing sector continues to hold its historic level of contribution to the GNP, remaining virtually unchanged since 1950. However, as a source of net new permanent employment opportunity management will no longer provide steady increase in new jobs.

We spent more than a year unearthing and analyzing every scrap of relevant and useful information on the effect of industrial restructuring on jobs and people. We became convinced that both management and workers must make a fundamental change in their historical relationship if either businesses or employees stand much of a chance of either successfully competing in a new worldwide market place or reconize any of the benefits we are convinced such successful competitive effort will bring to firms, their workers and to improving Americ's standard of living.

We believe it is extremely important to understand how these effects vary in manufacturing and helps explain more accurately what is actually occurring to workers, and how they experience displacement differently. It also explains and shows how displacement is concentrated among certain industries and regions jet at the same time identifies both those industries and regions where opportunity will continue to exist. We cite for example, electronics, non-electrical machinery, and primary aluminum products. It also included such surprising areas as fabricated metal products, metal working machinery and general industrial machinery.

Finally, it provides us with a much more accurate picture of why some displaced workers succeed in rapidly finding new jobs that pay close to their old ones, while others in the same jobs and the same industries experience considerable difficulty. It also provides us with a clear assessment of how many are suffering hardship and how many are not. We found that almost an equal number of dislocated workers have lost their jobs in service occupations and not in manufacturing, and that for all dislocated workers the actual number os those suffering hardship from job loss amounts tosignificantly less than 1 million workers. Those who require special attention number only half that or about 1/2 of 1 percent of the labor force.

Naturally, the question raises as to how much job opportunity is available and how worthwhile these new jobs are. As I have indicated, manufacturing as a whole will not serve its traditional role of employment opportunity. Instead, much of the new job growth and opportunity has and will continue to be found in services, which accounts for virtually all of the 21 million new jobs created between 1975-1986. However, we also found inaccurate the public impression that these jobs were on the average poorer paying replacements and less worthwhile than the manufacturing jobs being lost. In fact, according to the Bureau of Labor Statistics, the fastest rate of growth across the board is occurring in service jobs requiring higher order skills and more professional, managerial and technical competence.

In both public and private policy we feel that a fundamental objective is to better enable workers to take advantage of new and better job opportunity both before and after a job loss.

In the area of private policy changes, CED believes that both workers and companies need to undertake a fundamental reassessment of the trade-offs involved necessary to assure the competitive success of a business unit and the rewards that will be necessary in terms of pay and employment security for workers to make at times painful adjustments.

We believe that a first essential is open communication where firms provide employees with enough information to understand their role and their unit's role in the competitive success of an enterprise. This will require a major change in many current corporate practices. Second, if communication has provided the basis for mutual trust, both workers and employers must move away from traditional patterns of centralized bargaining which we can no longer afford and are much too rigid to a more flexible system where part of a worker's compensation, both up and down, is based on the competitive results of a business unit. A third area involves a fundamental reworking of employee benefits to enable, for example, severance pay, health benefits and pension to be conducive to employment adjustment and not a hinderance.

Finally, corporations must prepare workers further in advance of all decisions that will permanently affect a worker's employment conditions. We believe this must be done in a voluntary manner. Companies must also provide much more advance and continuous training and retraining designed to enable workers to move to new work both inside and outside of the company.

Similarly, we offer specific recommendations in public policy. Including specific recommendations to redesign Unemployment Insurance to serve as a greater incentive for faster work transition, and an administrative redesign of the Dislocated Worker Program under Title III of the Job Training Partnership Act to assure that it will be a more effective and more responsive resource for workers in plant closings and the like.

With specific regard to the Administration's $900 million dislocated worker's proposal, why we are concerned about its $500 million plus contribution to the deficit, we would support it in principle, provided it meets our test of effective transition assistance.

Our final area of concern is education. One important finding in our study of dislocated workers was that the extent to which the level of secondary education attained was the key determining factor in a person's ability to move rapidly to new work.

The same condition will hold true in the general economy for all current and perspective graduates of our nation's schools. In our policy statement, Investing in our Children: Business and the Public Schools, we found compelling evidence that the schools are not adequately preparing today's new job seekers or those in the future to meet the changing nature of jobs in the economy. It was also clear from a large analysis involving thousands of employers that the most required skills involved learning to learn, articulate and effective communication, good personal and disciplinary habits, and a strong sense of responsibility not only to their job, but to their fellow worker and to their role as citizens of a democracy. Surprisingly, we found this to be universally true among the hundreds of very large businesses and the thousands smaller firms and non-profits that we included in our survey.

As in our study Work and Change, our evidence convinced us that immediate changes needed to be made in the way that elementary and secondary schools go about preparing our nation's youth for a changing world environment. But, we cannot economically afford both in terms of social cost and critical loss of human resources the nearly 800,000 American students who will never finish school. Even worse, this number represents a small fraction of those who do graduate who will not be proficiently prepared with the skills required to meet the jobs of the future.

One highly respected economist has estimated that the effect of rapid technological change will lead to a total private sector demand of nearly 157 million total jobs by the year 2000, or a bare 13 years away. This represents more than twice of what was needed as recently as 1978.

The CED offers a series of carefully researched recommendations describing changes in school practice and resource allocation that have been shown to vastly increase the return on our tax dollar investment both for students and the economy. It also makes those fundamental curriculi and managmenet recommendations needed to more efficiently address the needs. It devotes considerable attention to the upgrade of the role of teacher in the work force and their need to play a much more professional role in the establishing of school policy and reform. We feel fundamentally that policy that begins at the classroom level up will always be better designed to address specific needs than policies directed from the state government without the direct involvement of local schools.

One particular recommendation evolves from findings we found compelling We found empirical evidence that established the benefit of good pre-school programming, particularly for the educationally disadvantaged, we found it a sure bet.

It was out of this analysis that led us to a further reassessment of the wider variety of problems affecting the education of the disadvantaged in our schools which prevents both older and younger students from taking advantage of their schooling. We intend to release the results of this study in early summer.

In terms of federal government support, we believe it should have a small role, except in the areas of research, program experimentation, and pre-school education. We are concerned that should the federal government return to their expanded role of the past that the states and localities which have recently been responding to the urgent need to improve educational quality and for greater resource allocation will quickly diminish. As we have indicated we believe that state and local policy will be

Mr. Chairman, I cannot close my testimony, however, without harking back to the urgency for remedial action as part of our macroeconomic concerns. Even if we achieve the longer run improvements I have mentioned, and other actions help to accomplish a gradual shift from deepening U.S. trade deficits to substantial trade surplus within the next five to ten years, we still are convinced we have a problem. The huge level of foreign debt of the U.S. government that as business and individuals we will continue to have to pay.

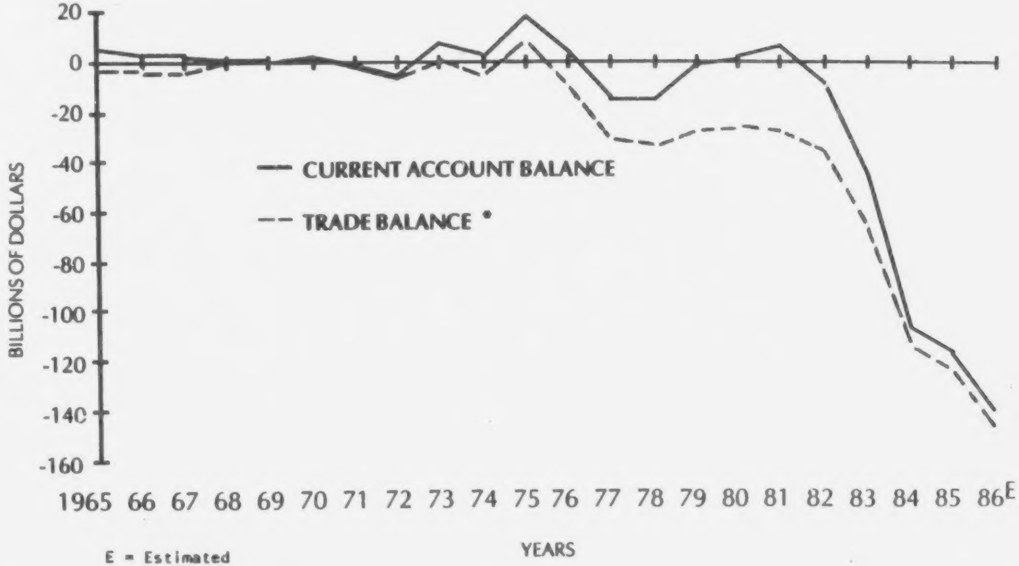
The final chart in our paper on the interrelationship of the federal and trade deficit, shows, the build-up of our foreign debt obligations will become huge. From a surplus level of well over $100 billion as recently as at the end of 1982, or just five years ago, at the rate we are going, the United States will accumulate an estimated total of $750 billion in net international obligations by 1990. In our view, this net borrowing from the rest of the world has enable the United States as a society to live well beyond our means.

A fundamental concern of this extended U.S. foreign debt is the increasing cost of serving that debt. We estimate that even to pay the net interest due on these accumulating obligations, let alone reduce the principal, the United States will be required to produce more than it consumes domestically and export more than it imports for years to come. Until the United States reestablishes a consistent pattern of balanced trade accounts surplus, the build-up of our foreign debt cannot be turned around. The worst part of this is that the money for serving and ultimately reducing the accumulated foreign debt will come directly out of the pockets of Americans in the form of declines in their potential future and standard of living.

Chart 1

The U.S. has run up enormous deficits in its international balance of trade and current account.

These trading deficits are graphic demonstrations of the sharp deterioration in international competitiveness that U.S. producers have suffered.



E = Estimated

* on a balance of payments basis

Source: U.S. Department of Commerce

(See Chapter I for details)

Chart 2

Trade Deficits of this Magnitude Seriously Damage Important U. S. Economic Objectives and Interests

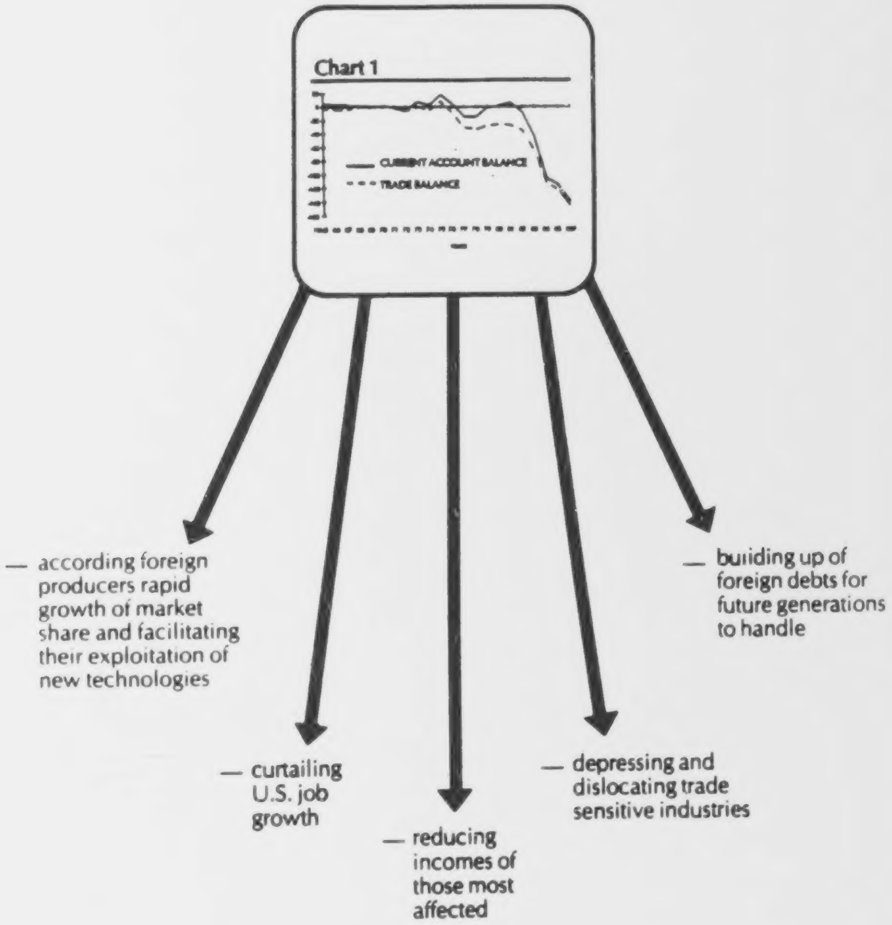
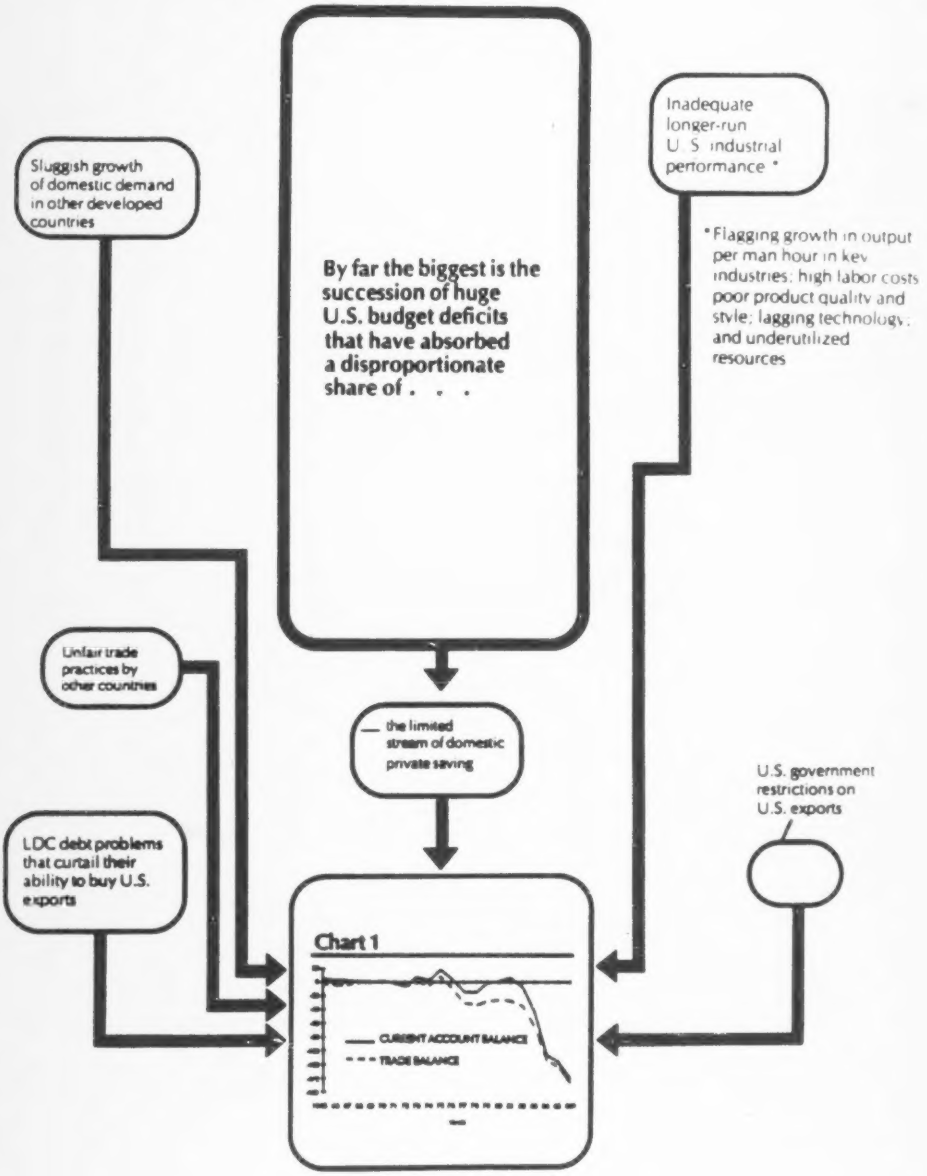


Chart 1
CURRENT ACCOUNT BALANCE
TRADE BALANCE
— according foreign producers rapid growth of market share and facilitating their exploitation of new technologies
— curtailing U.S. job growth
— reducing incomes of those most affected
— depressing and dislocating trade sensitive industries
— building up of foreign debts for future generations to handle

(See Chapter II for details)

Chart 3

What are the Main Causes of the Worsening U. S. Trade Deficits in the Last Five Years?


Sluggish growth of domestic demand in other developed countries
By far the biggest is the succession of huge U.S. budget deficits that have absorbed a disproportionate share of . . .
Inadequate longer-run U. S. industrial performance *
* Flagging growth in output per man hour in key industries; high labor costs; poor product quality and style; lagging technology; and underutilized resources
Unfair trade practices by other countries
— the limited stream of domestic private saving
U.S. government restrictions on U.S. exports
LDC debt problems that curtail their ability to buy U.S. exports
Chart 1
CURRENT ACCOUNT BALANCE
TRADE BALANCE

(See Chapter III for details)

Chart 4

What are the Most Important Steps to Take to Improve Competitiveness, Reduce Excessive U.S. Trade Deficits and Bolster U.S. Jobs and Incomes over the Next Five Years?

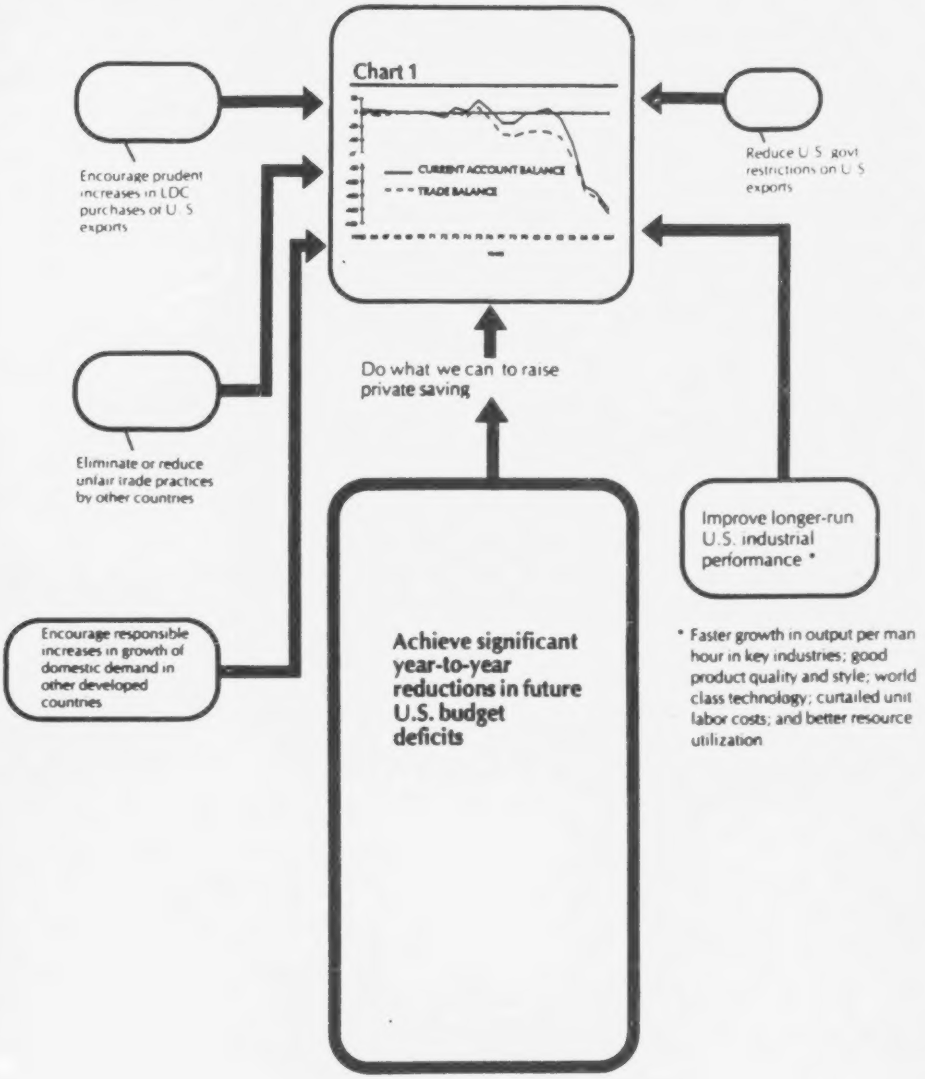


Chart 1
CURRENT ACCOUNT BALANCE
TRADE BALANCE
Encourage prudent increases in LDC purchases of U.S. exports
Reduce U.S. govt restrictions on U.S. exports
Do what we can to raise private saving
Eliminate or reduce unfair trade practices by other countries
Improve longer-run U.S. industrial performance *
Encourage responsible increases in growth of domestic demand in other developed countries
Achieve significant year-to-year reductions in future U.S. budget deficits

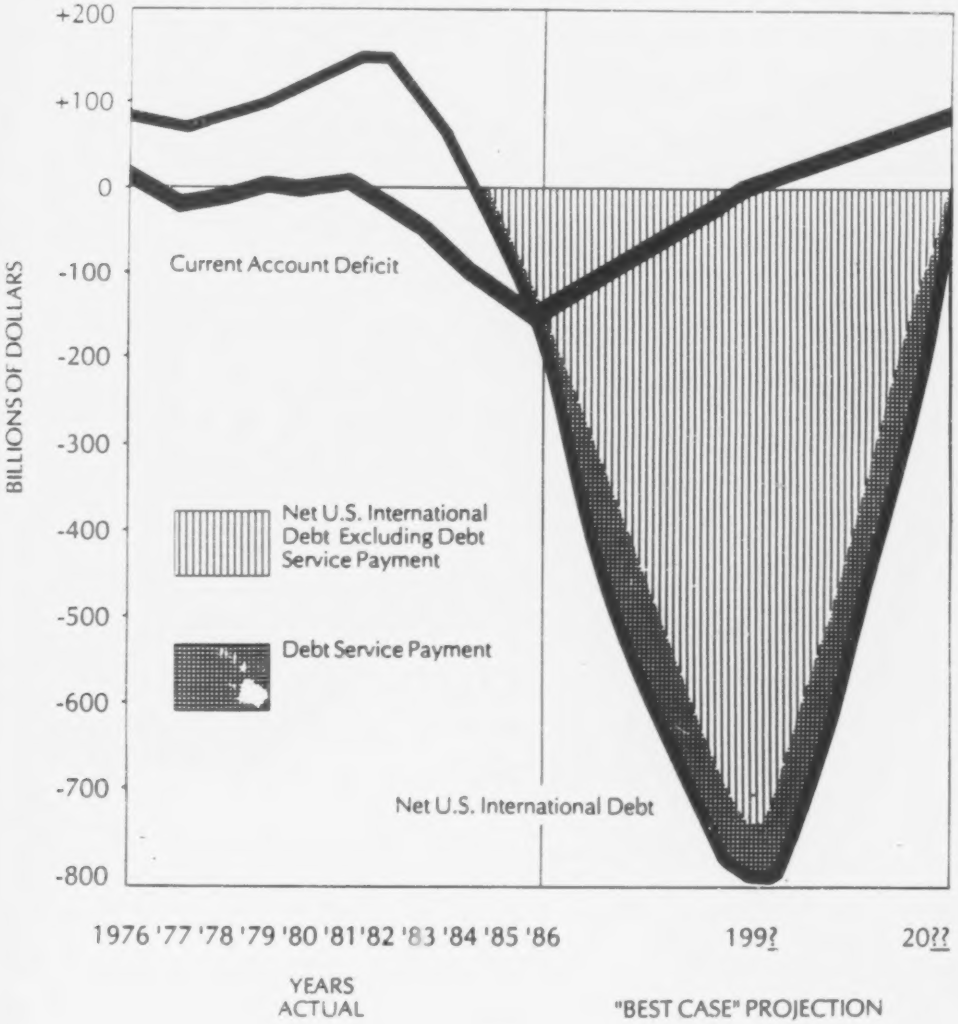
* Faster growth in output per man hour in key industries; good product quality and style; world class technology; curtailed unit labor costs; and better resource utilization

(See Chapter IV for details)

Chart 5

Net U.S. International Debt and Current Account Deficits

The U.S. will face a long period of net international debtor position even if its current account deficit begins to shrink or if it changes into a surplus.



(See Chapter V for details)

x

Chairman **Chiles**. Senator Sasser.

Senator **Sasser**. Thank you, Mr. Chairman.

VOCATIONAL EDUCATION AND TRAINING

One of the central elements to rebuilding our economic power is what is to be done about America's work force. Dr. Thurow and Dr. Choate, and I think Dr. Holland also, have indicated that education of the work force is a key part of this whole problem.

You indicated in your testimony, Dr. Thurow, that 70 percent of our work force will not attend college.

Dr. **Thurow**. Does not graduate from college.

Senator **Sasser**. Does not graduate from college. And we see before us through the administration's proposals a cut in vocational education to the tune of $900 million.

In your view, what is the importance, if any, of vocational education and training programs in training a work force to be able to meet our needs in the coming decades?

JAPANESE MORE SKILLED

Dr. **Thurow**. You see, I think we tend to have an elite view of the world. There is a very nice article in the most recent Atlantic Monthly, written by Jim Fallows, who is the contributing editor, who resides in Japan. What he basically says is that the bottom half of the Japanese work force is beating the bottom half of the American work force, and that is why we are losing, because at the bottom part of the Japanese work force, you find many more skilled people than you do in the bottom part of the American work force.

Take machine tools. One of the big reasons why machine tools is going down the tubes in the United States is you just cannot get the very skilled tool-and-die makers, machinists, people like that, that are terribly important to that industry.

I have been working with the Governor of Michigan recently on this problem, and companies will tell you, "We desperately need those people, but we could not afford to train them, because if we train them, they would instantly go off and get a job in southern California, working in the aircraft industry." Therefore, they need people, and at the same time they refuse to make that kind of training because we allow people to have labor mobility.

Now in Japan, that machine tool company would train the worker because the worker has no choice; he cannot leave. And I am not against labor mobility, but if you are going to have a system of a lot of labor mobility, you still have to have a training system for providing that kind of people.

It is exactly like the Army. You need good troops and corporals and sergeants if you are going to make an industrial economy work. I think our problem is not with the generals, not with the colonels, not with the lieutenants, even Our problem is down at the bottom part of the American industrial army, where we just are not turning out the kind of skilled people that the rest of the world is.

You go to Korea, and you go to the Da Woo assembly lines, and off the end of the Da Woo assembly lines come Pontiac 2000's. That is what they are now producing at Da Woo. And the people on that assembly line are more skilled than the people on the American assembly line.

Senator SASSER. So is it your view, then, Dr. Thurow, that we need to put more emphasis on vocational education as opposed to deemphasizing it?

VOCATIONAL TRAINING SHOULD BE ON THE JOB

Dr. THUROW. No; it depends on what you mean by vocational education. You see, I think what you want to do in secondary schools is get people up to high levels of literacy and mathematics. Now, maybe a vocational environment is the right way to teach the literacy and mathematics to get motivation. But the real place to do the vocational training is in the business firm, if you are thinking about doing a lot of it there. So I am all in favor of vocational training, but in this kind of cooperative public/private sphere as opposed to just doing it in traditional vocational high schools.

There are some very good traditional vocational high schools around America, but there are also a lot of very lousy traditional vocational high schools around America. And I think we need a new system.

It is going to spend some money. If we are spending $368 for the training per person of the non-college-bound as opposed to $17,000 of public money for every college student, that is just out of whack.

Senator SASSER. Would you care to comment on that, Dr. Holland?

VOCATIONAL TRAINING TOO NARROW

Dr. HOLLAND. I was simply want to underscore and reinforce Les's comment that what we need is a lot more training at the level of the workplace.

Also, I want to reinforce the comment that narrow vocational training in the public schools is not a good way to serve that objective. Our study and experience say what students most need to learn are the fundamentals on which work skills are based—communication, mathematics, work habits, willingness to work with one another, and good work discipline. Then, they can increasingly hone their specific skills in training within the workplace. I believe there are good opportunities for school/business cooperation to carry students from one right into the other, and there are excellent examples in a number of businesses and schools around the country where it is happening. It is spreading, and I hope it will be spreading fast.

COMPANY TEST GREATER THAN SCHOOL STANDARD

Dr. THUROW. Let me give you a dramatic example. In the State of Michigan, Mazda is setting up a facility. They required every employee on the assembly lines to pass a literacy test and a mathematics test. The test they require for a blue-collar assembly line worker is higher than the standards required to graduate from a Michigan high school. Now, if you think about that, you ought to weep. To be right at the bottom of the automobile industry in terms of occupational structure requires more literacy and more mathematics than the average Michigan high school will require for graduation. We cannot live with that very long.

Senator DOMENICI. Excuse me. Could I just clarify it?

Chairman CHILES. Yes.

Senator DOMENICI. Those who have lost jobs in that same industrial assembly line type business would not meet those tests for the most part.

Dr. THUROW. Absolutely not.

Senator SASSER. Dr. Choate.

Dr. CHOATE. If I might comment, I think there is a telling number. About 1 out of 5 Americans is functionally illiterate. About 1 out of 5 Americans has been to college. It is almost a normal distribution curve.

ECONOMICALLY AND FUNCTIONALLY DISADVANTAGED

It seems to me that what we need to do is to break the whole down into some parts. On the issue of the economically and culturally disadvantaged, many of whom are functionally illiterate, I think that we have said that the Federal Government would assume a responsibility through the Job Training Partnership Act to help finance that. And I think since 1982, we have had just about as good a system as we can expect to have. We have business, through the Private Industry Councils, working. That seems to me to be a logical and a right thing to do, because I do not think most employers are going to put up the money to pay for that.

UPGRADE SKILLS OF THOSE WORKING

The second challenge is how do you upgrade the skills of people who are already working. The question there is how do you get employers to invest more.

The American Society of Training and Development says that employers invest about $30 billion a year in training. But they also say that most of that training is done by our largest firms. Yet at the same time, most jobs are being created by medium- and small—size firms. Those firms by and large are going to depend upon the nation's systems of vocational, technical and community colleges to provide that training. And to that purpose, it seems to me again to be a national purpose for investment.

But the question is for what part of that investment. When you break down the numbers, 93 percent of the funding for that system is provided by State and local governments. It seems to me that perhaps, if there is a national purpose, it is to ensure that that system stays state-of-the-art; and increasingly, it is not.

The system was put into place in large part by Federal moneys, between 1965 and the late 1970's. Much of the equipment is antiquated, and correspondingly, much of the faculty skills are old. It is a minor part of the whole, but I think, a significant part of the whole, and it seems to me that there is a real national purpose.

DEALING WITH DISLOCATED WORKERS

The third part of the challenge is how do you deal with dislocated workers who are no longer affiliated with an employer—large or small—and in many cases do not really fit under the applications as an economically distressed worker.

Again, I think we are coming to the point as a country to say that it is not sufficient to label them as affected by trade or technology or shifts in consumer demand; that in effect, if they are dislocated, we want to get them reemployed and reduce unemployment insurance.

The proposal that is being advanced is to have the Federal Government pay for that. That may be the way to go. There are other options on how that can be done. The important thing is that we really do require a comprehensive dislocated worker program.

I would quibble with Bob a little bit on the numbers. There are fewer than 1 million displaced workers if you only consider those have 3 years of work experience. If you broaden it to all who are dislocated in a year, it is running about 2 million workers a year. And many of those workers will require education and training.

Senator SASSER. What is the definition of dislocated worker?

Dr. CHOATE. One who has been involuntarily separated from his or her employment and there is no prospect of going back to that job; in other words, the job has disappeared.

Senator SASSER [presiding]. Senator Danforth?

IS PROTECTIONISM ANSWER TO COMPETITIVENESS

Senator DANFORTH. Gentlemen, as you know, Congress is going to be dealing with trade legislation proposals this year. Do any of you believe that protectionism is the answer to our international competitiveness problem?

Dr. HOLLAND. I do not.

FREE TRADE A MISNOMER IN SOME CASES

Dr. THUROW. If you put the question that way, of course the answer is no. Do I believe free trade is the answer to our problem? The answer is also no. I am with Mr. Choate here, exactly as to what he said earlier. The problem is in the world economy, we deal with some very different economies. And if you are talking about trade between the United States and Great Britain, then free trade as we know it is the answer. If you are talking about trade between the United States and the Soviet Union, there is no such thing as free trade; it does not even have any meaning in that kind of a context.

And I think the point he made needs to be emphasized. If you are thinking about something like the Japanese economy, I think his description is absolutely right. It is a planned market-driven economy. And out there, you have a whole set of activities that would not occur inside the United States; a whole set of activities that make it very difficult for an American firm to get in.

And it is not protectionism in our sense of the word protectionism; it is a different type of economy. And we need to have some kind of system for dealing with that kind of an economy. If that is what you mean by protection, then I am in favor of protection.

I do not think you can deal with the Japanese on trade issues exactly like you deal with the British on trade issues. They do not have the same kind of economy. So he and I are right together on that one.

OPTIONAL APPROACHES TO COMPETITIVENESS

Senator **Danforth**. Well, I suppose there are generally three options. One is to do nothing; one is to erect the barriers on the theory that the United States really cannot compete—other countries' wages are lower than ours, other countries have moved ahead of us for one reason or another, we cannot compete in foreign markets, and let us not try to—and the third approach is what a lot of people call the reciprocity approach. It is to try to fashion some mechanisms for opening up other markets.

Dr. **Thurow**. I think there are a lot of choices other than those three. One choice is that we inside the United States have to do things to raise our own rate of growth of productivity, both in and out of manufacturing. Manufacturing is good relative to nonmanufacturing, but American manufacturing has a lousy productivity growth rate relative to either the Koreans or the Japanese or the Germans. Those are things we have to do at home, and it relates to the kinds of things we have been talking about this morning.

RULES MUST BE SET FOR DIFFERENT IN-COUNTRY ECONOMIES

You see, I would argue that the GATT has gone completely off on the wrong dimension in this new GATT round. The problem of the world economy is not how do you bring agriculture into the same system with manufactured goods, or how do you bring services in. The problem is how do you define a set of rules for how countries sensibly trade with each other when they want to operate economies inside their country that are very different from each other.

Japan does not operate an American economy, and they are not going to operate an American economy. But we still want to have productive economic relationships with the Japanese, and we have to work out some set of trading rules that seem sensible to both of us that we are then both willing to live with—like, for example, how much money can government give to a private firm to finance research and development. Outside of the military, we do not do much of that in the United States. Other countries do a lot of it. Is that unfair or fair?

Well, the answer is there is no international rule in any treaty that we have ever signed or suggested or the Japanese have ever signed or suggested that says what is fair or unfair.

It is not that somebody is violating the rules; it is that there are no rules. And I think it is those kinds of things that we have to work out, and I think they are very different than your three choices.

Senator **Danforth**. Dr. Holland.

Dr. **Holland**. I would emphasize different things, I think, than Les and Pat would emphasize on this score. They are quite right in saying there are a lot of interferences with the free markets that are being used by other national governments such foreign government interventions are giving us fits on this score, and I think they need to be attended to.

MARKET-ORIENTED APPROACH STILL THE BEST

But I believe working in a market-oriented direction with our own actions, and urging foreign governments to work in that direction also, is still the most productive way to go.

I am all for more effective pressing in these directions. I think we have an ally here we sometimes do not recognize. The forces of economic globalization are playing on all the economies of the trading world, Japan as well as us. They are producing changes in Japan that are pushing her away from some of the stereotypes of Japan, that appear in the press, just as they are playing on our country and pressing us in directions that are different from our past. I see those forces as ones that can be allies of the United States, because I believe we can have a more adaptive economy to those forces than our other major competitors.

That is why I am talking about a more flexible, a more adaptable U.S. economy, and a more flexible and more adaptable work force, too.

IS NEW TAX POLICY WRONG

Senator DANFORTH. Let me ask one other question. We have undergone a major change in tax policy in this country. Basically, the theory has been to reduce individual tax rates, to increase taxes on our manufacturing sector, and to target in various ways higher education. The tax bill is in place now—I do not happen to like it.

But do you think that the strategy we are following in tax policy is the right one or the wrong one? For example, capital gains. We used to have a capital gains differential. We used to say to people, well, we really want you to invest in capital assets and hold onto them for a while. Now we say that there is no difference between capital investment and ordinary income; turn it over as fast as you can, make a quick buck.

We used to say that we wanted businesses to invest in new plant and equipment. Now we say that we really do not care much if you do or do not. The tax benefits are not going to be there.

We used to say that we thought that education was particularly important in this country. Now we say we are going to tax scholarships and fellowships; if you borrow for your college expenses, you are not going to be able to deduct interest on student loans. We are going to put a cap on borrowing by colleges and universities.

Do you have a feeling that maybe we are heading in the wrong direction in tax policy?

Dr. HOLLAND. I, like you, Senator, was not a fan of some of the ingredients in that tax reform bill. I have a double-jointed answer I would give you on that score.

One is, now that the tax reform bill has become law, I think it may be worthwhile to wait a bit, give people a sense of some certainty as to what the tax structure is, see what the effects are, and then correct it and move on from there.

Secondly, the idea of moving from a highly-differentiated to a more uniform tax structure had some appeal intellectually to me and to others as well. I think the point of greatest vulnerability would be if we did not do other things through other devices of public and private policy than taxes to serve some of the worthwhile purposes that we formerly had been using tax incentives to do.

I am not a great fan of tax incentives, to be honest with you. There are some activities in this economy that you may be able to encourage more efficiently with a tax incentive than with other devices. But I think there are a good many areas where we have fallen in the habit of using tax incentives, where in point of fact there are better ways to incent a socially desirable result.

I think some of the specific actions that Pat and Les and I have been talking about in education, for example, are really better ways of incenting the kind of improvement we are talking about in education than a generalized tax credit or tax incentive.

I cite that as just one example.

Dr. **Choate**. My concern would be on the long- and short-term activity. Regardless of what one does in the tax bill, it is going to have some consequences.

NEW TAX POLICY ENCOURAGES LONG-TERM ACTIVITY

My observation about the present tax code is it does encourage more short-term activity rather than long-term investment. It seems to me that there are a number of opportunities that are presented, however. It seems that there would be an opportunity, for example, to put in a shared compensation system, given this need. I think we need some shared compensation systems anyway, to better link performance and rewards, and perhaps one way to do that would be to alter the tax code in a manner that says that at the beginning of the year all workers—an executive, or anyone in an institution—could choose how they would be paid. They could be paid precisely as they are now, or they could take part of their compensation in stock. That stock would not be taxed until it was sold, and the longer you held it, the lower the rate; you would be taxed at a very high rate initially, but those rates would decline over time.

Obviously, what you are trying to do is to bias the whole of the organization and the management structure toward thinking long-term.

Again, I question whether or not we should permit the pension funds and financial institutions to engage in trades that pay no taxes whatsoever on the short-term turnover of those funds. I think this has created an environment where many of the managers of those funds are moving in and out, and in the process, are destabilizing the market or at least biasing it for short-term speculation rather than long-term investment.

So it seems to me that there are a number of areas where some corrections could benefit us in our long-term competitiveness.

Senator **Danforth**. Dr. Thurow.

Dr. **Thurow**. Well, I agree with the comment that was made earlier. People exaggerate the size of the effect that the tax code has on these decisions.

In 1981, we put in huge incentives for capital investment, and we got slightly more capital investment. In 1986, you all took them out. The only thing we know is that you were either very inconsistent between 1981 and 1986, or one of the two times you were smart, and the other time you were stupid. You cannot have it both ways.

I think the problem with supply side economics was not that it was not right that taxes have some impact on the system, but they grossly exaggerated the size of the effect. And I think they grossly exaggerated how positive the effects were going to be in 1981 by lowering taxes on business capital investment, and some of them are grossly exaggerating now what the negative effects are going to be on removing those incentives.

They are going to have some marginal impact, but it is not the heart of the system.

CODE MAY ENCOURAGE AMERICAN OVERSEAS PRODUCTION

Dr. **HOLLAND**. If I may, Senator, the one aspect of that tax change that I have heard the most surprising and troublesome comment about concerns the change in the way investment and earnings in overseas operations of American-owned corporations are treated. That change may be turning out to create a kind of incentive to add to production facilities overseas, and that does not thrill me at all. I have not seen enough evidence for me to be able to tell you exactly how much that is happening and how it balances out, but I have heard it often enough for it to concern me.

Senator **DANFORTH**. A disincentive for Americans to go overseas and try to make sales and do business and locate themselves individually to create a market for U.S. products.

Dr. **HOLLAND**. Yes.

Senator **SASSER**. Gentlemen, Senator Wirth has been sitting here, waiting patiently for an extended period of time. I think we ought to turn to him now.

Senator Wirth.

Senator **WIRTH**. Thank you, Mr. Chairman—not only waiting patiently, but as always, enjoying the very, very productive comments by Dr. Choate and Dr. Thurow—and Dr. Holland, I am not sure we have talked before, but I have read a lot of the CED material, and I have great respect for your organization. I thank you all very much for being here.

SEMICONDUCTOR INDUSTRY

There are a whole array of things in front of us, and I would like to start maybe, instead of the big things, with something a little bit smaller. Let me ask you about semiconductors.

You all have probably seen the report from the Defense Science Board, suggesting that the Defense Department undertake a major initiative of about $1.5 billion over a 5-year period of time. You all are familiar with that set of recommendations.

Dr. **CHOATE**. Yes.

Dr. **THUROW**. Yes.

Senator **WIRTH**. Let me ask you a number of questions about it, if I might. First of all, is the problem as severe as the Defense Science Board suggests? Pat, do you want to start off?

Dr. **CHOATE**. From the information I have seen, it certainly appears to be. Certainly, the concern should be real. Semiconductors will be the "steel," in effect, of the 21st century.

Senator WIRTH. Les.

Dr. THUROW. You have got to ask yourself is Japan our ally or aren't they our ally. Suppose all semiconductors are made by the Japanese. They are not our enemy, I do not think.

I think there is something major wrong when a brand new industry like semiconductors basically collapses in terms of its market share, but I do not think it is a Defense Department problem. I think it is much broader.

Senator WIRTH. Yes; but leave aside where the jurisdiction sits. I mean, is the problem severe in terms of what we ought to be concerned about in terms of the U.S. economy, thinking about what are the——

Dr. THUROW. Oh, I think as a symbol of things going on, we ought to take it very seriously. But whether it is a military problem, I question.

Senator WIRTH. OK. Let me come back to that.

Dr. Holland, just severity alone—is this a severe problem that we in the U.S. Congress and people in the country ought to have close to the top of the agenda, a severe problem?

Dr. HOLLAND. Close to the top of the agenda, no. Important problem, yes.

One of the reasons I seem to deemphasize that industry problem a bit is because I think in that industry and in a number of others, the capability of the U.S. portion of that industry has been sadly handicapped by what has happened in the exchange rate. That comes partly back to what is happening with the budget, as I tried to say in my formal remarks to you.

I think if we had had a steady-state exchange rate between the dollar and the yen over the last decade, we would have still had semiconductor troubles. But we would not have had the extreme boom and bust kind of pattern.

Senator WIRTH. Yes, but here we are in February 1987. We are figuring, OK, where do we go from here.

Dr. HOLLAND. I understand.

SHOULD GOVERNMENT STEP IN SEMICONDUCTOR INDUSTRY

Senator WIRTH. Let me ask the second level of questions. If in fact all of you agree in one way or another that it is a severe problem—some are higher up the escalator than others—the question is, is it proper, then, that the Government intervene. Is there any other way by which we can break into this problem?

Dr. CHOATE. Well, it seems to me that there are two basic sets of interventions that perhaps will make sense. One deals with our trade policies with Japan—the ITC case, for example, where the Japanese were found to have been dumping, and the allegations that even after an agreement was reached last summer, that perhaps that dumping has continued in Third World markets.

This really means that across-the-board, that needs to be very closely monitored and brings us back to some very tough negotiations. That is one.

Senator WIRTH. OK. Say that the Japanese stop dumping tomorrow.

Dr. **Choate**. Oh, yes, oh, yes. We are talking about the various interventions. That certainly is one intervention. The second level of intervention is do we have the research, the money, the sharing, the motivation, the impetus; is Federal money required? I would probably ascribe to what the Defense Board and the industry are saying, that it probably is yes.

Senator **Wirth**. OK. Les, do you have anything to add?

INDUSTRY STABILITY CRITERION FOR GOVERNMENT INVESTMENT

Dr. **Thurow**. You see, if you ask how they got in trouble, it was partly their own fault. And then the question is, well, do you want to do a public debate on that.

For example, because of the things he mentioned about short-term orientation, every time there was a recession and cutback in the demand for semiconductor chips, the American firms quit building facilities and cut back on their research and development. During the same recession, the Japanese would be building facilities and continuing their research and development.

So if you look at market share, the American market share of semiconductor chips goes dramatically down at the end of every American recession, because when you have a comeback in the American economy, the American companies say, well, we do not have the facilities, and they quote an 18-month delivery time, and the Japanese give you 6 weeks on delivery. So, before I put a lot of money in semiconductors, I would want a lot of real negotiations with that industry about how their behavior was going to change in the future before I just gave them a couple billion bucks for research and development.

Senator **Wirth**. But with negotiations—in fact, you are saying that you negotiate, but we have got to intervene; is that right?

Dr. **Thurow**. Well, you can make an argument that even if it happened due to management stupidity, you still cannot afford to let the industry completely disappear.

Senator **Wirth**. And in fact negotiation by itself is interfering with the free hand out there, right?

Dr. **Thurow**. That is right. I have always taken the proposition that any time you are going to put any kind of Federal money into any particular industry, there ought to be very detailed equivalents of contracts signed as to what that industry is in fact going to do as a quid pro quo for that Federal money.

Senator **Wirth**. Dr. Holland.

Dr. **Holland**. Well, I do not believe in our society our Government is a very good fixer of private industrial failings. You can look at the track record.

Senator **Wirth**. So you do not think we ought to intervene?

NO GOVERNMENT INVESTMENT

Dr. **Holland**. I do not think that is our strong suit. I am all for pressing the points of unfair advantage, conferred by a foreign government or unfair support and subsidy, dumping and so forth, that have been raised. I recognize there have been some questions about whether we signed quite the right kind of antidumping agreement. I think we ought to keep banging away on that score. But I would go very slow in terms of putting a lot of U.S. Government money into the industry to try to preserve it.

Senator **Wirth**. There are third and fourth questions that then flow from this. I know the red light is on, but maybe I can go ahead and ask the third and fourth questions, if I could do that.

Senator **Sasser**. If we can get brief answers.

WHAT ISSUES DOES GOVERNMENT INVESTMENT RAISE

Senator **Wirth**. The third question relates to what kinds of precedents we may be setting, what are we opening the door for, and what other questions does it bring up. Fourth, if we do so, does it follow that there are specific pieces of legislation that should come along with it, or that this case should be a case study to stimulate discussion of such things as you have talked about before—Pat, the need for various kinds of research cooperation and perhaps changes in the antitrust law; and Les, you have talked about trying to coordinate in some fashion research to have a big domestic darpa or something like that.

So what kinds of issues does this raise in terms of opening the door, and then what kind of changes legislatively do we have to make?

Dr. **Choate**. The first question is many of the responses of American firms over the past 10 years may, when viewed in retrospect, have been very rational, because you have had wild fluctuations in the exchange rate, you have had the U.S. Government unwilling to stop predatory trade practices that in effect can drive people straight to the wall.

So in that sense I think a conditionality argument has great validity. But I think also it has to be recognized that perhaps government has some shared responsibility with the industry itself to in effect offset many of the policies that it has had in place. And that seems to me to be very appropriate.

GOVERNMENT PARTICIPATION DOES NOT SET PRECEDENT

To the second question, if such is done, it is not in itself setting a new precedent, because when one looks back over time, you find dozens of precedents—our computer industry, our jet aircraft industry, many other industries——

Senator **Wirth**. Railroads, interstate highways.

Dr. **Choate**. Have in effect been created.

It would seem to me for the longer term that there is much to be gained by building up our university lab systems and our national lab systems and recognizing that there are generic technologies that are of benefit to all industries and that those industries would benefit from joint R&D, relaxations of antitrust laws, and Federal moneys being expended on that R&D.

So I see much gain, and I really do not see that much on the downside. And it fits very much within our historical pattern over time.

Dr. **Thurow**. What you are talking about doing, obviously, is industrial policies——

Senator **Wirth**. No, no. Strike that from the record. [Laughter.]

INTERVENTION IN ONE INDUSTRY TOO NARROW

Dr. **Thurow**. OK. That is a dirty word—I understand—a four-letter word. But what you are essentially doing is having an industrial policy for a particular industry under the cover of a military guise, when everybody knows it is not really the military we are worried about, because if you just want chips for American airplanes, you can buy them from the Japanese.

I think if you are going to do something like that, you ought to think about it in a bigger picture sense. MITI has just opened what they call a Key Technology Center in Japan which is putting government money in working on four, five, six key technologies——

Senator **Wirth**. Winners.

Dr. **Thurow** [continuing]. Winners—in this public-private cooperation, and who is to say that semiconductor chips are more important than new materials for the future of the American economy. And I would much rather see us have a National Science Foundation for Industry which dealt somewhat with semiconductor chips and other things at the same time, rather than a specific program just for semiconductor chips, because somebody could make an implausible argument that it is important to the defense establishment.

Senator **Sasser**. Do you want to respond to that, Dr. Holland?

Dr. **Holland**. I will try to be quick. I would not do a specific bailout of the semiconductor industry. Instead, I would press stronger government support for basic research because I think that is where we have some real competitive advantage. Paired with the right kind of policies to open the doors between those laboratories and the industrial production lines, I think we could fertilize a broader and more sustainable kind of industrial strength than a one-industry bailout.

Senator **Wirth**. Thank you, Mr. Chairman.

Senator **Sasser**. Senator Domenici.

IS JAPAN'S EDUCATION BUDGET BIGGER THAN UNITED STATES

Senator **Domenici**. Thank you very much, Mr. Chairman.

Let me quote. We had a panel on education that included David Packard. One would have thought we would not have had David Packard on a panel on education. This is almost a quote. "Raw materials and natural resources are no longer the foundation of our economy. Knowledge is now the most important element in our economy."

Now, that is a very, very difficult statement for me to comprehend in the sense that it seems too philosophical. But when I let my mind wander on what "knowledge" means, you all have been talking about that, I think.

Second point. Does Japan spend more, do any of you know, overall, using some relative thing—percent of GNP; is that a relative thing to use these days—do they spend more on education than the United States of America?

Dr. **Thurow**. The answer is they do not spend more. They pay teacher much more money per teachers and have bigger classes. And one of the myths of American education where there is just no evidence that it pays off is small class size. So the Japanese spend, as I remember the numbers, just slightly less as a fraction of the GNP than we do on education, but they pay each individual classroom teacher much more money than we do, and they do it by having many fewer teachers and much bigger classes.

HIGH EDUCATION OUTLAYS AND STILL FALLING BEHIND

Senator DOMENICI. Actually, I know the answer. You are absolutely right. Ours, as best we can figure it, is around 7 percent of GNP, just this thing we call education. That is not the companies training people. They spend 5.5.

But Dr. Thurow can make the statement he just made because he does not teach in a public school, and he already has tenure at the institution he is at.

But there is no question that if we add that 7 that I just told you about, that we spend on education, my numbers say another 7 percent of GNP is spent on training, retraining, and all matters related to it. Now, I am not sure that is right, but let us just use it for this discussion.

If it is true, we are now at 7 plus 7, which is 14 percent of GNP. That is one-seventh of our GNP spent in the broad sense on either formal education or training and retraining.

I did not hear any of your testimony—you tell me if I heard you right or wrong—indicating that that number is too small, and it ought to be larger.

Dr. HOLLAND. Senator, my testimony in effect called for a little more spending on primary and secondary public education. We certainly are prepared to see some more dollars spent there. They might be able to be offset with some savings elsewhere in the educational system, but I am not sure of that.

Senator DOMENICI. I do not mean it in that context. I heard that, and I was especially pleased with your early childhood development emphasis. I guess I am asking in the macro sense.

Does anybody really believe that it is because we are only spending 14 percent of GNP in the area I just described, that that is one of the very significant reasons that we are lacking in whatever this thing we are calling competitiveness, or——

Dr. THUROW. I guess I do not believe your second 7 percent.

Senator DOMENICI. I said maybe that is not so. So what if it was 4, what if it was——

Dr. THUROW. You see, I have seen a lot of comparative studies done on how much money does Toyota spend on training versus Ford. They are two companies which are very similar in size, produce almost exactly the same number of cars. Toyota spends a lot more money in training its work force than Ford.

In all those comparative studies I know where you take company by company, industry by industry, you compare Germany, Japan and the United States, the German or Japanese company always comes up spending more money on the education and training of its work force on the job than the American company does.

I would love to see where that other 7 percent came from, but I guess my basic gut reaction is I do not believe it for a minute.

SPENDING MORE—GETTING THE SAME RESULTS

Senator **Domenici**. Well, I guess the point I am trying to make is that it is terribly frustrating for us, frankly, who want to see change in the way we prepare ourselves for competition. It is terribly frustrating when we talk of education and training while we watch America's policies, governmentally speaking, inch along by way of change, if any change at all—yet we might be spending more. I do not know if I am making my point.

It seems to me we do not take that next step. If we are going to spend $2 billion more in the private and the public sector, it seems that we do not do that in a way that is up to the change that is needed, but rather, it is spent on more of what we have been doing.

SCHOOL YEAR TOO SHORT

Dr. **Thurow**. Senator, let me tell you something that will get me hung by that public schoolteacher as opposed to just a brick thrown at me. I would not pay public schoolteachers one nickel more than they are now being paid as long as they work a 180-day school year.

Europeans go to school 220 days. Japanese go to school 240 days. And if you are going to pay a high way to a teacher, you have got to have full-time, full-year work, and that is the only way our children are going to learn.

It is a form of American chutzpah to think that we can learn in 180 days what it takes a Swede 220 days to learn and a Japanese 240 days to learn. And for that, I will get crucified by the public schoolteachers of America.

Dr. **Holland**. We need to not spend more, but spend better. The way we are spending a lot of those educational dollars now gets very poor returns on those outlays. We can up the rate of return on our educational spending, I think.

Senator **Domenici**. Well, I did not get in here to choose sides in this debate. I think you have been very forthright and very helpful in that regard, and I compliment you for it. I really think the Chairman and I just in a very small way have had a very difficult time when we put $1.6 billion new money in for education, and we truly think somebody is going to do something new—and I am not critical of my brothers in the U.S. Senate—but they do not do anything new. I mean, they put it right back into things we have been doing, and it seems to me that even when we put NSF in the budget for their 12 percent increase—we have done that a couple times—I do not know if NSF is the greatest tool to move our universities and private sector, but we do not seem to have anything else yet. Some of us are thinking of something better. But we might put it in, and it might get spend for—who knows—something else, but not for that.

But you wanted to answer my previous question.

EDUCATION MONEY TO PAYOFF LATER

Dr. **Choate**. I just wanted again to come back to the distinction, at least, education and competitiveness. All that we do in the K through 12 system will really come into play in the 21st century, or the late 1990s.

The real crunch on competitiveness is going to occur in the last years of this decade and the first 5, 6, 7 years of the next decade. And in that sense, the real issue is a question of how do you retool today's workers.

Now, in that challenge, it seems to me we are talking about relatively minor amounts of moneys.

EMPLOYERS NEED TO INVEST MORE

The second question is one of how do you get the American employer to invest more. That seems to me to be a critical question because, unlike at least the large Japanese employers—Toyota, Nissan, Mitsubishi—where you have lifetime employment, you do not have that in this country. So many employers are reluctant to make the investment because they are fearful they are simply subsidizing somebody else when that worker shifts jobs.

So the question really becomes one of how do you give employers the same incentive to invest in improving the skills of their workers that you give them to improve their technology and their capital facilities.

In other words, if there is to be some subsidization here, then you should equalize it between the three factors of production.

Senator DOMENICI. Mr. Chairman, I just want to engage the three witnesses in the next round for another 5 minutes, but I will yield at this time.

Chairman CHILES. Thank you very much.

HOW TO FORCE OPEN JAPANESE MARKETS

Pat, in writing about the high-flex trade strategy, you talked about the Japanese response to our demand for opening their markets. You write, "When forced to open their markets, the Japanese have responded by making minimal concessions and then building assembly operations in the protesting nation. These investments have several trade-related advantages for them. For one, they allow the Japanese to avoid import quotas. Since the operations involve little more than assembly of Japanese-made kits, the profits and best jobs remain in Japan. Permitting such branch-plant investment to continue unregulated is sure to convert the United States into a locale for low-value-added, low-wage work assembling parts designed and manufactured elsewhere."

Given Japan's behavior, which keeps markets closed and makes sure that profits from their foreign investments stay in Japan, how should we respond? What should be our counter-strategy with regard to imports, exports, and investments?

NEW LEGISLATION

Dr. CHOATE. I think there are several things. One, in legislation that you previously introduced, you have spoken to the need for reciprocity. I think that should be one of our objectives.

Governor Bruce Babbitt of Arizona has proposed a scheme that would create balance. In other words, nations that have a continuous export balance with all other nations would be forced over time to make certain mechanical reductions, or other nations could impose tariffs. That appeals to me.

U.S. MUST MANAGE ECONOMIC RELATIONSHIP

For the longer term, I think with the Japanese, increasingly, we are going to have to manage our economic relationships with them much tighter than we now do.

Ours is a process-oriented system. Theirs is a results-oriented system. And for them, those results are increasingly market share. That market share can be achieved—through exports or it can be done through investments. We need to remember, for example, the auto quotas that the United States imposed in 1981—a scheme that was devised by MITI and proposed to the U.S. Government in 1980.

One of the things I believe that MITI sought from that proposal was not only to limit auto exports for political reasons, but also to encourage their companies to locate their assembly operations—what you would call "screwdriver operations"—in the United States. In such operations, you have a warehouse called an assembly plant where all of the parts are brought in, and as Dr. Thurow is saying, most of the value-added and the best jobs are retained in Japan.

But what now happens increasingly is that once those networks are put into place, you will see many of the parts operations move to the United States, and again, many of the parts will be assembled here, while much of the value-added will be kept in Japan. In the process of moving in, then, a whole chain of linked industries can be penetrated, such as engineering, construction, et cetera.

It seems to me that the Japanese economic system is very different from our own, the cultures are very different, we have great difficulties penetrating those markets, and when penetration finally comes, it comes at a high cost and only after a long period of time. Clearly, we need to recognize these differences and in effect negotiate with the Japanese on such things as the relative levels of imports and exports that we will permit, relative levels of investment here and there, the reciprocity, the technological exchange that would be permitted here and there—and I can say more about that later on—and the relationships in Third nations, how we compete in Third nations, so that we are not caught with dumping practices as a means to penetrate our markets.

Chairman CHILES. Thank you.

SERVICE SECTOR PRODUCTIVITY FALLING

Dr. Thurow, lately we have been hearing a lot about the service sector, most of it negative. What I have not heard, though, is the assessment of how this service sector is going to contribute to our long run economic power. We know services account for 65 percent of the Nation's GNP and 75 percent of our employment. Three-quarters of all the manufacturing costs represent support services, and we know it is a major market for our U.S. high-technology; 80 percent of the computing and communication-related information technologies go to that service sector.

But the bad news is that our service sector productivity is appalling. Chairman Volcker told us that growth in our service sector productivity has been zilch, and that it is growing four times faster in Japan than it is here. So that scenario is depressingly familiar.

With services playing that increasingly important role in our economy, doesn't our ability to build an economic power depend on raising this productivity? And knowing that that is true, how do we bolster productivity growth in the service sector when we do not seem to even know how to measure it right now?

Dr. THUROW. I do not actually think in services our real problem is imperfection in measuring service productivity. If you are talking, for example, about utilities, kilowatts of electricity, it does not take a genius on measuring kilowatts of electricity. And we have lousy service productivity and growth in service industries where there is no problem whatsoever in measuring the output of that industry.

So that in some industries, in some parts of services, there is a problem.

SERVICES CAN'T CARRY THE LOAD ALONE

Now, the right way to think about it is not services good or bad. Services and industry are linked together, and you have got to think of them as a whole. But as I pointed out in my testimony, we have a deficit in international service trade already. In 1985, it was a $3 billion deficit. In 1986, in the third quarter, it was a $4 billion deficit. Because if you look at what we import and export in terms of services, we are not particularly good at many of them, and we are losing market share very rapidly in some of them.

For example, if you think about insurance, what is the insurance capital of the world? Well, it is Lloyd's of London—not the United States. So on insurance transactions, we lose $3 billion. Our net payments to them are $3 billion more than our payments from foreigners for selling them insurance.

If you look at financial transactions, we still have a surplus on fees for financial transactions, but not for very long, because the people who rule the roost in terms of financial transactions are the world's big lenders. That is the Japanese banks. And Fortune magazine has just put out its latest 10 largest banks in the world, and the Japanese bank has just passed Citibank to be number one. There are seven Japanese banks, one American, and two French.

And if you look in third markets like London, last year the Japanese did more of the business than the American companies did.

So if you systematically go across those services, what you will find is that we have many weaknesses, and the one place where we have a big surplus on service sales abroad is sales of technology. We have an $8 billion surplus on selling or leasing or renting technology to the rest of the world, but that is a number that is going to get smaller because we do not have the huge technical lead on the rest of the world that we used to.

Tourism is an American disaster. We lose $12 billion a year on tourism. We have a high probability to take European vacations. Europeans do not have a high probability of taking American vacations, even when there is a low-valued dollar.

So when you look at the service sector, it is important. But what I was objecting to was this kind of idea that somehow you can just let manufacturing go and services are going to carry the load. The numbers just are not there.

Dr. HOLLAND. May I come at this a different way, Mr. Chairman, just a second?

Chairman CHILES. Yes, sir.

SERVICE AND MANUFACTURING INDUSTRIES LINKED

Dr. HOLLAND. I think we need to recognize that what is meant by services—the kinds of personal and intellectual activities that the term "services" implies—is now taking place within much of what the statistics label manufacturing.

Inside the standard manufacturing company, a lot of the value-added now is in effect a service-type function. In a sense, the kind of knowledge that Dave Packard pointed to and you referred to, Senator Domenici, is a powerful factor of production for this country. It is becoming more important in this country and in the other industrialized countries. That is one of the reasons that we are putting stress on the need to make more effective use of that kind of knowledge.

Dr. THUROW. Let me tell you one of the reasons why service productivity is rising very rapidly in the rest of the world and not in the United States, and it leads you back to something that is not conventional American wisdom.

I have a French graduate student who is working on services in France and the United States. In France, service productivity has been rising even faster than manufacturing productivity, and their manufacturing productivity is rising faster than our manufacturing productivity.

The reason is that they provide services with very different amounts of capital. They use a lot more capital in the service sector than we do, partly because of their minimum wage. Our minimum wage is $3.35 and widely ignored. So in the United States, you can hire very cheap workers, and you do not do services with a lot of capital equipment.

In many European countries, the minimum wage is 80 percent of the average wage, which puts it up at $8 or $9 an hour. And if you have to pay a service worker $8 or $9 an hour, then you employ a lot more capital in those service industries than you do in the United States.

For example, take ski resorts in France versus the United States. You will find that American ski resorts have many more people on the payroll and use a lot less capital equipment.

Chairman CHILES. Well, I am not sure that is all bad.

Dr. THUROW. Well, it may not be all bad, but——

Chairman CHILES. I mean, what the heck are we going to do when we have got all the factory workers we cannot deal with? What are we going to do if we have got all the ski resort workers we cannot deal with?

Dr. THUROW. But let me tell you the difference. For example, if you go to a Swiss ski resort, there is never anybody checking your lift ticket. You put a card in an electronic device that says whether you get on the lift or not. There is nobody helping you open and shut the door on the gondolas; that is all done automatically.

So what you have, partly because of these very high minimum wages in Europe, is you have a very different structure of how they provide services in terms of capital equipment.

If you take parking lots, in Sweden, there is never somebody at the gate of that parking lot, an actual human being. You put a card in the slot and make the parking lot work.

So if you want to know one of the secrets of having a higher rate of growth of productivity and services, it is have a higher minimum wage. Now, that is not a very sellable idea, but it——

Chairman CHILES. It does not sell with me.

U.S. GOVERNMENT/INDUSTRY COOPERATION

Dr. Choate, in your testimony, you outlined the five types of economic systems that we face, and you also talk about countries like Japan, which you characterized as "plan-driven". We know the government is a very direct participant in their national export drives.

While it would be certainly unwise for us to mimic their every action, don't we have something to learn from the Japanese about cooperation? Haven't we undermined our own competitiveness by insisting that industry-government cooperation is to be avoided at all cost? Are there areas that you see such as research and development—and Dr. Holland, I would like your answer to this, too—training and education, and building our competitiveness and infrastructure where the government could facilitate the efforts of the private sector?

Dr. CHOATE. Well, I think there are many areas, Mr. Chairman. First of all, I think one of the big differences between our type of economic system and theirs—Korea's, Singapore's, Taiwan's, and others of that genre—is the fact that trade, the welfare of their economy, and exports have a top priority.

Economic decisions or decisions that are made by government are considered; also, among other factors, what will it do to their competitiveness. And I hope out of this competitiveness debate, if any one thing occurs, that the implications of government decisions on U.S. competitiveness will at least be considered.

GOVERNMENT/INDUSTRY CAN COOPERATE

It seems also that there is a wide array of areas where there can be some productive cooperation between business and government. One of these deals, for example, is the question of technology exchange and further advancement in technology.

I realize that one of the high-priority areas that you will be considering this year is more money for R&D activities. But I would raise a question, and that is, will that necessarily lead to more productivity and competition and a stronger economy. I have some real questions about this because of many of our policies on technological reciprocity.

In essence, I think that what we may well be doing is continuing to serve as a science base for the rest of the world, including many of our competitors. I have one basic thought that can point that up.

Great Britain has the highest number of Nobel Prizes per capita than any other nation. The question, I think, that we are going to need to address increasingly is how do we have technological reciprocity. Other nations have full access to our technology through our universities, through student exchange programs, being able to participate in research that is done by our national labs. We do not have that access with many of our primary technological competitors, primarily Japan. We have difficulty getting our professors and post-graduate students into those programs. We have difficulty participating, if at all, in this research consortia and the activities they undertake. We have real problems getting access to much of that information to even translate it into English.

Another point that I think is relevant is that last year, the Congress appropriated, I think, $1 million for the National Technical Information Service, a little-known agency, to translate Japanese scientific and technical documents. I think that is very important.

Now, in Japan there are 9,200 science and technology and engineering journals. Only one-quarter of those are translated into English.

Now, the fact of the matter is, most American corporations simply do not have people who can make the translations that are necessary, and most of our universities do not. Moreover, the Japanese language is so difficult to learn that the prospects of our training a vast number of people in the private sector to make that translation is slim, if not nonexistent over the next 3 or 4 or 5 years.

What we really need to do is to have government, on a comprehensive basis, take that data, translate it, put it up on the NTIS, and make it available to our scholars and to our industries.

Those are just a few possibilities.

Chairman CHILES. Thank you.

Dr. Holland.

Dr. HOLLAND. I would go for a spirit of greater public-private cooperation in a number of areas. I think we see some excellent examples of public-private cooperation in this country most predominantly at the local level, where the individual business, the individual plant, the individual school, the individual city government and so forth are, in one way or another, beginning to make things happen together. We see it in worker training; we see it in education to help bring drop-outs into the work force; we see it in designing economic development programs for communities, now starting to spread to the State level. I think that kind of thing is worthwhile.

NO FEDS IN INDUSTRIAL DEVELOPMENT

I do not see a major role for a federally directed or a federally sparked vision of industrial development, picking winners and losers and that kind of thing, at all. That is not where I see we have got our major payoff.

I think we also have some great gains to be made at the Federal level from funding the development of our comparative advantage in technology and the creation of new thought and new knowledge. Pat and Les have both cited some numbers that give evidence of that.

I like what Pat has to say about translation of information. I think there is also the major area of intellectual property rights where vigorous government action could do something to help give us a more level international playing field. We are spilling a lot of our technology overseas with a lot less reciprocity in that area than in some of the product areas that have been grabbing headlines.

COOPERATION NEEDED IN PROCESS TECHNOLOGY

Dr. THUROW. I think there is a major place here where the Federal Government has got to play a role. You see, if you look at where we are weak, it is not on new products; it is on process technology. We invent the video recorder, but then we cannot make it at competitive cost, because we are lousy at the process of building consumer electronics.

The problem with the National Science Foundation as it now exists, and with our history, is that you cannot do process R&D at the university. You can only do process R&D in the process of production. And all of our major competitors have some national device for funneling money into process R&D. And that has to be a device for funneling money one way or another through firms as opposed to through universities.

Now, universities can be cooperative in that process, but you cannot do process R&D in a university laboratory because you have got to have the whole production process sitting there in front of you to work on it.

I think this whole question of process R&D is a major American weakness, and it is going to require a new American institution, a new set of cooperative relationships between companies and government as to how you do that kind of funding for process R&D.

The military used to do that when it made millions of tanks and millions of ships. There was a part of the Defense Department that worried about manufacturing technology and manufacturing efficiency. But the Defense Department has become a handicraft industry—they make six of that and seven of this, and they pay very little attention and put no money anymore into these mass process industries, because they do not mass-produce anything.

CHANGES NEEDED IN BUSINESS AND FINANCIAL INSTITUTIONS

Chairman CHILES. Dr. Thurow, in your book, "Zero Sum Solution", you have a phrase that comes right out at the heart of many of our competitive problems. You say institutions matter, and you tell us that how we organize ourselves is critically important. "It is simply no longer true that in today's global economy, the United States will come out on top no matter how we organize ourselves."

I can think of numerous institutions in America that might benefit from careful scrutiny. I wonder about the shortsightedness of our financial markets, the way other countries do a better job in delivering that long-term capital. I have to wonder about the long-term commitment of businesses that give up whole areas of technology, allow our competitors to reap billions in profits. We do not produce VCRs anymore. We see a lot of areas like that.

I listened to many of the criticisms that Treasury Secretary Darman has raised about American industry's ability to manage.

Can you tell us how our institutions, particularly our business and financial ones, how they must change to survive in this global economy, and what do you see as an appropriate role for government in getting them to change?

MUST CHANGE DEPRESSION ERA REGULATIONS

Dr. **THUROW**. Well, one of the appropriate places echoes something that has already been mentioned this morning. I think you need to go back and rethink and redo a lot of those financial regulations that were passed in response to the Great Depression.

For example, one of the reasons why it is very hard to penetrate other markets and why they do not have to worry about some of these short-term time horizons, the Deutschebank, for example, controls 400 industrial corporations in Germany, including Mercedes Benz, which is the largest corporation in Germany. The managers of Mercedes Benz do not spend 1 minute thinking about the German stock market. They do not spend 1 minute thinking about mergers and takeovers, because nobody is going to take them over without the cooperation of the Deutschebank, and if the Deutschebank does not like the current managers of Mercedes Benz, they simply fire them and get new managers.

The same thing is true—Mitsubishi Bank owns 20 percent of Mitsubishi Electric; Mitsubishi Electric owns 20 percent of Mitsubishi Bank. You have a much closer interaction between the financial-industrial structure of these countries.

What we did in the 1930's was build up a whole set of financial institutions that said the right solution of the problem is a very arm's-length relationship between finance and industry. And what that has produced over the years is we have basically made industry into a plaything for finance. And we have got to change those laws so that turns around, because it is just madness. I know corporate presidents who have somebody come into their office every 30 minutes and tell them what is happening on the New York Stock Exchange that day to their shares. That is not what the manager of a major industrial corporation ought to be spending his time doing. He ought to be spending it on very different things.

So I think you really need to go back and look at a lot of those financial regulations and the way we set up our financial system in the early 1930s and ask, given a modern industrial economy, what should those things look like.

You see, I think a lot of them are technologically obsolete. We had this idea back then that if you compartmentalized finance, then if any compartment went broke, it would not bring the whole system down. But with modern technology, those rules have basically become obsolete, but they lead to some perversions in the system.

So I think this whole question of how we set up finance—you see, I would say the Anglo-Saxon disease is giving finance primacy over industry. That is what we systematically do in this country. When you think about it, if the President offered you the job of Secretary of Treasury or Secretary of Commerce, it is laughable. But if you were in Japan, and the Prime Minister of Japan offered you the job of Minister of Industry and Trade or Minister of Finance, you would take Industry and Trade; it is the more powerful job.

And I think we have just got to rebalance this whole system of how finance and industry interrelate with each other.

Chairman CHILES. Dr. Holland.

DEFICIT CAUSES DISRUPTIVE EXCHANGE RATE SWINGS

Dr. HOLLAND. I would like to hark back to what I talked about before, Senator. For all the problems we have inside our own industrial structure, I believe those problems have been exaggerated in our minds and in their impact because of the huge, sustained swings in exchange rates that we have undergone, particularly over the last 6 years. These have been much greater swings than would ordinarily be called for by simply the adjustment of purchasing power parity that the textbooks speak of.

We have experienced finance-driven, sustained changes in our exchange rates that have disrupted productive activities in our country and in some others, too. That experience is a very costly one in terms of what it makes happen inside our economic system.

If I could leave you with one appeal, it would be to consider what you can do for a more level playing field in terms of exchange rates, as well as in terms of a level playing field for semiconductors or automobiles.

And when it comes to how to obtain a more level playing field in exchange rates, the Paul Volckers of this world can fiddle around in the exchange markets a little bit and make a little bit of difference—perhaps ever a big difference for a day or two or a week or two—but the fundamental forces are the major market flows. And our budget deficits and their financing over the last half-dozen years have been a major force in giving us a profound competitive handicap in the exchange rate field. Until you get the budget under control so that we can have a more stable playing field in the exchange markets, it will continue to be one of the big malefactors on the scene.

DEFICIT REDUCTION NO QUICK FIX

Dr. THUROW. Let me take slight issue with that. I am all in favor of you doing something about the Federal budget deficit. In fact I have advocated a Federal budget surplus, because the Federal budget deficit is negative savings and lowers the amount of savings we have in an already low society.

But if you think for one minute if you cured the Federal budget deficit tomorrow morning that this exchange problem and competitiveness problem would disappear tomorrow afternoon, or even 2 years from now, that is just absolute madness.

Dr. HOLLAND. No; that is not what I said, Les.

Dr. THUROW. Hold on, now. We have had a $200 billion deficit for the last 4 or 5 years. During that period of time the dollar has gone up from $1.70 to $2.85 and back to $1.50. Nobody has done anything about the Federal budget during that period of time.

We have had this huge swing in exchange rates. When we had a Federal budget deficit, it was up to $2.80. We have still got a Federal budget deficit, and it is down at $1.50. The idea that you just correct the Federal budget deficit, somehow the exchange rates are all of a sudden not going to be volatile, all of a sudden are going to be at the right level—or, not even all of a sudden, even be at the right level within 2 or 3 years—I do not know any evidence that that is right. And the evidence that it is wrong is the fact that we have gone from $1.70 to $2.85 back to $1.50, although we had a $200 billion deficit.

If there was any tight connection between the Federal budget deficit and that international exchange deficit, you would not have had those wild swings in exchange rates while you have had this constant Federal budget deficit.

Now, that does not mean I am not in favor of getting rid of the Federal budget deficit. I very carefully said I am, but for very different reasons—because it is negative savings, and it is a drain on the American economy, and it means we are going to invest less. But the idea that curing the Federal budget deficit is going to straighten out our international problems, I just do not think that is in the cards.

Dr. HOLLAND. Les, I think the budget deficit is a very important factor in the total. That leaves room for other things as well. But it is not trivial. It is a very important factor in the total.

And it is not true that we have not done much on the budget deficit. This committee and your counterparts in Congress have changed the——

DEFICITS DID HAVE EFFECT ON DOLLAR LEVEL

Chairman CHILES. Well, I think it is also a little bit explainable, Dr. Thurow, how that deficit has caused that same cycle in that dollar exchange rate. The longer it went on, the dollar went from high to low. Part of it, of course, is that we were talking it down at the time and beginning to drive it down. But I do not think it is totally unexplainable that the deficit itself was not affecting that rate. The point you make, I think, is valid, but we cannot look to that to be the only——

Dr. THUROW. Let me make another point. Part of the reason the dollar went way up to $2.85 is we had 22 percent interest rates.

Chairman CHILES. Sure.

Dr. THUROW. Even if we had had a balanced budget during that period of time, because of fighting inflation, we would have had very high interest rates because the Japanese did not have inflation at that period of time. So let us say interest rates in the United States would have been 17 percent rather than 22 percent if we had balanced our budget. Well, if they are 5 in Japan, which they were, we are still going to have a big increase in the exchange rate.

Chairman CHILES. But again, if we had not had that tremendous deficit, we would not have had a 22-percent interest rate, and Japan would have probably had to do something a little bit different because we would not have had that need for all of that foreign investment and borrowing of money.

I think the point you make is valid, that it is not the only thing that will affect it.

Senator Domenici, we need to conclude.

G-R-H GOOD EFFECT ON EXCHANGE RATE

Dr. HOLLAND. Senator, Mr. Chairman, I want to just say one more thing. I want to give this committee some credit. There are numerous forces at work back and forth in the markets that make some of the day-to-day and year-to-year fits untidy between budget deficits, exchange rates and trade deficits. But I believe the budget deficit is still a fundamental factor—not the only, but a fundamental factor—more important than any other force we can put our hands on during this last 5 years.

When the dollar was at its worst, this committee and other responsible forces were saying we had a budget posture which not only gave us close to $200 billion current deficits, but had a future $300 billion annual deficit built into the programs in place. Now, thanks to actions for which I give you and your colleagues in the Congress some credit, there is a $100 billion outyear deficit embedded in the current budget programs. We have not achieved those cuts yet, and there is a lot of hard work to do to get there. However, the Gramm-Rudman-Hollings legislation put a different coloration on political attitudes toward budget deficit reduction. I think those changed attitudes have their effect through the exchange markets, too.

I give you some credit, even though you will be reading very harsh language from CED that says we have to get the budget deficit down more than we have.

Thank you.

Chairman CHILES. Senator Domenici.

UNITED STATES HAD TO CHANGE POLICIES

Senator DOMENICI. Mr. Chairman, I, like you, must go on, I assume, to another event.

But let me ask just kind of a philosophical question and talk with me for 1 minute.

It seems to me after the Second World War and in the aftermath of the Soviets in Europe and communism spreading there, we installed the Marshall Plan there and got nations coming back strong, and then we did everything we could to help them remain free industrial countries. We clearly dominated Japan for a while, but we were in a very real sense asking that they get into the business of becoming an industrial power. We did not want them to have much to do with military, but we surely wanted them to learn some things from us and get on with producing and selling goods in the marketplace.

We had a war in Korea, and in the part that was free, a wide-open door to teach everything we could teach them. We wanted them to produce. They all have done that.

Was it not inevitable that a significant change had to occur—I am not saying all bad result—but did we not have to change our basic way of doing business sooner or later in light of the evolution of those particular competitors in the world, to say nothing about the cheap labor countries that are producing specialty items. Do you not think it really had to happen sooner or later?

Dr. THUROW. I think it was absolutely inevitable that they were going to catch up with our standard of living and they were going to become more competitive.

It is like being a rich person, living in a poor neighborhood. It is more comfortable to live in a rich neighborhood, even though you are sometimes envious.

Now, the problem, however, is the British problem in 1900. In 1900, we and the British had an equal per capita income. By the time we get to 1986, the British have a per capita income half that of the United States. So you want the rest of the world to catch up, but you do not want the United States to fall behind.

WE HAVE NOT RESPONDED TO NEW REALITIES

Dr. CHOATE. Well, I think our policies from 1946 through 1973 beneficially served us and served the rest of the world. You had an expansion of global trade. They were very much the right policies. But after the oil shock, given the catchup that other nations have done, after we were willing in effect to have an unbalanced set of relationships with other nations, and they did catch up, I think that really, for a period of 12 or 14 years, we simply have not responded to the new realities.

We must, I think, increasingly treat nations such as Japan as equals, and as equals in effect demand certain behavior from them just as we will expect to have certain behavior toward them.

LIVING IN TRADE NEVER, NEVER LAND

What I am arguing is that in the process of redefining those relationships, that we define them in the context of the way that they are. We need to recognize the fact that about 93 percent of global trade, commerce and investment is not covered by the GATT and that 75 percent of global economic activity is done by economic systems that are far different from our own. What we need to do is give ourselves the freedom, intellectually and politically, to negotiate with those nations as they are on individual bases.

Dr. HOLLAND. Senator, I would answer your question yes, you are absolutely right. The change was inevitable. And I could write you a long letter about why it happened and why I think it does not mean that our policies were bad in those early post-war years. They were good, but we became awfully fat and complacent.

Now, however, I believe we see real signs of vitality and resurgence within the U.S. social and industrial structure that are quite encouraging. European business leaders are coming to visit this country under CED auspices to find out, "Where is the source of vitality inside the American industrial complex; where is it coming from? Your industries took a blow that would have driven us to our knees, and you fellows are fighting your way back."

Senator DOMENICI. I think Senator Chiles would not disagree—I forgot to ask—but we had some testimony that we wanted to receive from Mr. deVries. Could we hold it open to receive that from him? We will put that on the record, now, and unless the chairman objects, it will stay on there.[1]

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[1] See p. 380.

WAY TO PRIVATELY USE GOVERNMENT LAB TECHNOLOGY

Let me just close with a thought. If any of you who have names of any people I might confer with on this notion, I would just greatly appreciate it.

I have now concluded that it is very difficult for the United States—and I am not so sure I am arguing with this difficulty—it is difficult for us to parlay things that we do for one public purpose into general public use. I will give you a couple of examples.

It is very, very difficult for us to take Lawrence Livermore Lab, Los Alamos Scientific Lab, and maybe six or eight others—giant, giant multidisciplinary institutions—easy to create for their original purpose, and they are anomalies. They were created for defense purposes, for deterrent purposes, or some such thing, and here they sit. It is very, very difficult to use them for something broader than they were originally intended for, because they become an anomaly in the private sector; they become an anomaly among the university systems.

I truly believe that evidence is conclusive that for the dollars spent in those kinds of major multidisciplinary facilities, in everything from physics, all kinds of conventional science, genetics, an incredible array of knowledge with some of the finest minds in the world—and incidentally, many of those institutions have had the Nobel Laureates there; I think the one at Los Alamos had three of ours who lived there for a long time.

I have the notion that somehow or another, without causing a lot of commotion in the Congress, that we have got to find a way, since they are in place and cost us $5 or $6 billion a year and are multidisciplined, to use them far more significantly than we are. And I do not care how many Executive orders you have that will let us transfer technology more efficiently. That is not going to work. There is something basic we have got to use them for, and we are not.

I think I need a few scientists and industrialists. If you have a few suggestions—I think I have enough of the other people that I am talking to—but if you have a couple of ideas in that regard, I would greatly appreciate your submitting them to me privately for my own edification and use.

Dr. THUROW. Let me give you one publicly. Ken Olsen is the head of digital equipment, and he basically got his original ideas when he worked in the Lincoln Laboratory, which is a government laboratory run by MIT, like Lawrence Livermore is run by Berkeley.

Senator DOMENICI. And where is he now?

Dr. THUROW. He is the head of Digital Equipment Corp., which is the second-largest computer corporation. And since he has direct experience with taking knowledge out of a government laboratory and making a successful private company, I would suggest that he should be high on your list.

Senator DOMENICI. Good. If you can think of some, Dr. Holland, would you get me a couple of names? I want on this end industrialists. I have got the educators, previous legislators. Those kinds of people, I am talking to.

Dr. **Holland**. I will be glad to. And I might give one or two names that will surprise you, too, off in the soft sciences, because I think some of the throw-off is going to be in that direction.

I applaud very much your thrust, Senator. I think those laboratories are in effect "acres of diamonds" in our own back yard that we are not tapping nearly as well as we should be.

Senator **Domenici**. Thank you.

Senator **Wirth**. Senator, it will give you great solace to know that I was born in Los Alamos. You probably did not know that.

Senator **Domenici**. I did not know that.

SOURCE OF SAVINGS TO MEET BUDGET TARGET

Senator **Domenici**. Gentlemen, while we have got you here—we are close to the end of this—this is the last hearing we are going to have before going into the process of starting to mark up a budget.

We are currently looking at a deficit of $171 billion. As far as I know, the question of numbers has not come up this morning—maybe I missed it, but I do not think it did.

Let me ask the three of you if you were sitting where we are sitting, looking at a deficit of $171 billion, what would you target to be the deficit at the end of fiscal year 1988, and where would you get that savings?

Dr. **Thurow**. Let me start. I think you have got a problem which the American corporation has. You cannot make that decision without asking yourself what is the rest of the world going to do. Let us suppose you could wave a magic wand and cure the Federal budget deficit, either by raising taxes or cutting expenditures—it does not make any difference. If we just did that in isolation, all we would do is cause a world recession.

If you were going to balance the Federal budget in the Federal Congress, you would have to have the Germans and Japanese onboard, willing to do some offsetting policies in terms of lowering interest rates, expanding their economies, doing a whole set of other things out there in the world. And you would have to have Mr. Volcker making some very explicit promises about what he is willing to do with interest rates inside the United States.

So I think that is not the kind of thing where you can give a hard answer just by introspection inside the U.S. Congress, because we now really are in an integrated world economy where what you can do with the Federal budget deficit depends partly on what the rest of the world is going to do.

Now, if the rest of the world is willing to be cooperative, then the answer of anything you could do to reduce the Federal budget deficit would be a big positive. Now, I have a simple answer which is not very popular politically. As I read the entrails of what is in the Federal budget, the answer is that when we become serious about balancing the Federal budget, we will do it mostly with taxes.

We will do it mostly with taxes for a very simple reason. If you take government spending, State, local and Federal—and that is the only way you can do it when you compare countries, like the Japanese national government runs the schools so that is in their national budget—if you take that percentage, we in the United States spend 32, 33 percent of the GNP in Government. Some very frugal people like the Japanese and the Swiss also spend approximately 32 or 33 percent of the GNP in government. They do not have any defense budget.

Now, if the frugal Swiss and the frugal Japanese think you need 32 percent of the GNP to provide basic public services, I find it highly unlikely that the United States is going to get by for much less than 25 percent of the GNP on public services, since we put 7 percent in defense.

TYPE OF TAXES TO CUT DEFICIT

Therefore, you say when are we going to cure the Federal budget deficit—I think it is going to be mostly taxes, and if you say mostly taxes, there are two obvious choices. One is the gas tax. You raise $1 billion for every penny on the gasoline tax. The price of oil now once again seems to be going down. As the price of oil goes down, it is the perfect time to put on a gasoline tax, because you basically do not have to raise the price of what the people are buying when you put the tax on.

The other tax that the rest of the world uses very heavily that we do not use at all is the value-added tax, which I also know is a political no-no. But when we become serious about the Federal budget deficit, I think we will close most of the deficit using one or both of those taxes.

Senator **Wirth**. Let me ask you what kind of numbers, Les. The deficit is at $171 billion. We do not have the luxury of waiting for Mr. Volcker and discussions with the Germans and the Japanese and so on. We have got to put some numbers into the first cut of the budget. How much should we be going after to keep the pressure on lowering the deficit and increase our own savings as you were suggesting, but without doing harm to the economy.

Dr. **Thurow**. Well, I think the answer then is that you probably cannot count on doing, say, more than $30 billion worth. If you get the deficit down by $30 billion, that is probably about as much of a negative shock as the economy could take without tipping it over into a recession if nobody else is going to do anything else.

Senator **Wirth**. Pat?

Dr. **Choate**. Well, it seems to me it is a question for the economy, or are we going to take the bad medicine now, or are we going to try to push it off until later. Given the number of players that Lester suggests have to be involved, when you begin to analyze them, it seems to me that the wild card in all of that, then, really becomes the Congress. And if the Congress will take many of these steps—the Congress and the administration—then others will eventually have to follow suit even if it does mean perhaps pitching us into a recession.

MUST TAX TO MEET BUDGET TARGET

Perhaps we should not move that off the table as an option. I concur with Lester that the primary source of a reduction of this deficit is going to have to come from taxes, and I think most people really realize that. The issue is how is that done in a manner that seems fair and equitable.

Well, the gas tax is a good way of doing that, and it will be relatively painless and hopefully, fairly acceptable. At the same token, ultimately, a value-added tax, a consumption tax of some form is going to have to be imposed.

But it seems to me that the real question is essentially one of when do we want to bear the pain. I think that we are better off bearing the pain earlier rather than later.

Senator **WIRTH**. Dr. Holland.

SPENDING CUTS TO CUT DEFICIT

Dr. **HOLLAND**. I feel like Pat does in terms of when the pain ought to be born. I would think right now. If I personally were sitting where you are today, I would cut between $35 and $40 billion off the fiscal 1988 budget deficit, in solid, honest cuts. Use smoke and mirrors to get from there to the Gramm-Rudman-Hollings target, if you want—they will probably reach—but $35 to $40 billion in honest cuts in the deficit is what I mean.

Then I would look to some improvement on the trade deficit side and a significantly easier financial atmosphere (out of a combination of monetary accommodation and the lower interest rates that I think would come out of this process) to help offset the dampening effect of that kind of a deficit cut.

I am not as worried, about the dampening effect of budget deficit reduction as some, because just as much of the stimulative effects of our budget deficits over these past years have spilled overseas vis our deepening trade deficits, so some of the dampening effects of our budget deficits reduction will spill overseas in a shrinkage of our trade deficit.

We will need the easier interest rates and the accommodative monetary atmosphere to make this big transition work well, but this is a a very good time for budget deficit reduction to lead the parade of adjustment, not lag once more.

JAPANESE ASSESSMENT OF U.S. GNP GROWTH

Dr. **THUROW**. Let me put one question mark in the back of your mind. The administration is now forecasting, what, a 3- to 3.5-percent growth rate. Do you know what Nomura Securities thinks we are going to grow next year? One and a half.

Now, the Japanese are not right on everything, but the Japanese estimates for how fast the American economy is going to grow are much slower than the American estimates, and that is important, because the American estimates are 2.5 or 3 percent because we think we are going to improve our balance of payments; and they are basically betting that we will not improve our balance of payments, and therefore we will not have the growth from a $20 to $30 billion improvement.

Senator **WIRTH**. That is about a $40 billion difference in terms of the deficit.

Dr. **HOLLAND**. But partly, Les, I think it is because they are betting the Congress will not do much on the budget deficit, either, if you take apart that Nomura forecast.

Senator WIRTH. Gentlemen, thank you very much for a morning very rich in testimony and discussion. We greatly appreciate your being here and, as ever, look forward to working with you.

Thank you very much.

[Whereupon, at 12:12 p.m., the committee was adjourned.]

STATEMENT OF RIMMER de VRIES, SENIOR VICE PRESIDENT, MORGAN GUARANTY TRUST CO.

THE G-5 COMMUNIQUE: AN APPRAISAL[*]

Ministers of the Group of Five (G-5) industrial countries, plus Canada, recognized at their February meeting that the U.S. and other large trade imbalances "pose serious economic and political risks." Maintaining, however, that the substantial exchange rate changes that have occurred "will increasingly contribute to reducing external imbalances," they went on to assert that their currencies are now "within ranges broadly consistent with underlying economic fundamentals, given the policy commitments summarized in this statement" (emphasis added). Their communique concluded by proclaiming agreement "to cooperate closely to foster stability of exchange rates around current levels."

The new G-5 position should be evaluated in relation to today's interrelated imperatives of rectifying the U.S. trade imbalance and, at the same time, bolstering growth in the leading industrial economies to bring them closer to economic potential -- both for their own sakes and to provide the thriving export opportunities so vital for the solution of LDC debt problems.

Although the U.S. trade deficit may narrow by $20-$25 billion or so this year from the $166 billion of 1986 (see

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[*] Statement submitted by Rimmer de Vries, Senior Vice President, Morgan Guaranty Trust Company, to the Budget and Foreign Relations Committees of the U.S. Senate in March 1987.

Chart 1), it looks unlikely to fall below $100 billion annually during the remainder of this decade on the basis of present exchange rates and national growth policies. Economic growth remains less than robust in the United States and is faltering in Japan and Germany, whose exports are in trouble and macroeconomic policies restrictive.

After two years of warnings of the risks of inaction, both Japan and Germany remain profoundly averse to what they consider "artificial" domestic policy stimulus. Instead, they crave a more stable dollar -- in part, to avert the inflation and interest rate risks to the United States from too low a dollar but also to retain a competitive edge for their own economies. It is further argued that the twin U.S. deficits, on budget and trade, are closely linked and that both can be tackled effectively only through U.S. fiscal stringency.

The United States has begun taking its fiscal medicine, probably in larger dosage than generally recognized. Budget restraint alone, however, may not meet FDA standards for safety and effectiveness in promoting trade deficit correction and satisfactory world economic growth simultaneously. The outcome depends on policies beyond exclusive U.S. Administration or Congressional control. For example, if U.S. monetary policy is now to be dedicated to dollar stability at current exchange rates, U.S. interest rates likely will have to have to be higher than would be otherwise necessary. Instead, U.S. fiscal restraint should be matched, indeed outdone, by a prudent combination of easier U.S. monetary policy with fiscal and, to some extent, monetary policy relaxation in Japan and Europe. With easier, yet responsible, U.S. monetary policy, the U.S. economy would enjoy competitive benefit, without suffering permanent inflationary harm from the further drop in the dollar that would likely ensue. But it requires policy relaxation abroad as well to enable cononic growth generally -- in the United States, the other industrial countries, and the LDCs -- to come out ahead even as imbalances are put right.

Trade adjustment to date

The U.S. trade deficit climbed on the CIF valuation from $148 billion in 1985 to $166 billion last year, despite a $15 billion savings on oil imports. With estimated oil saving of $19 billion and $9 billion respectively, Japan's trade surplus jumped from $56 billion to $93 billion and Germany's from $30 billion to $58 billion. Measured in dollars, it is unclear that the surpluses of Japan and Germany are coming down. As for the U.S. imbalance, January's red ink of $14.8 billion is consistent with the view that the deficit has stabilized but not that it is narrowing. Although the U.S. bilateral deficits with Canada and Europe have edged a little lower during the past twelve months, they have widened with Japan and spectacularly with the Asian NICs (see Table 1).

The price and exchange rate valuation changes consequent to the dollar's two-year decline have masked substantial adjustments in volume terms. Overall U.S. import volumes have continued to increase but the pace has moderated. While some foreign suppliers have made strong new inroads into the U.S. market -- for example, Korea in automobiles -- the volume growth of U.S. manufactures imports generally has eased from the explosive pace of three years ago to 10% in the second half of 1986 (see Chart 2). By contrast, volume growth in Germany's imports picked up from 4.6% in 1985 to 6.1% in 1986 as a whole, although the pace slackened toward the end of the year. Following stagnation in 1985, Japan's import volume picked up steam in 1986, growing by 13.4% overall. Excluding the special factor of temporarily large gold imports, Japan's manufactures import volume rose 12%, albeit from an extremely low base.

Although January seems to have brought a new, and probably temporary, setback, overall U.S. export volume jumped 9% in the final quarter of 1986 above the third-quarter level. This was a significant change of direction, following steady declines that amounted to 22% in manufactures and 36% in agricultural products from the end of 1980 through the third quarter of 1986. Both Japan and Germany appear to be losing market share and sales volume in the U.S. market. Japan's overall export volume, which attained a peak growth rate of 16% in the first half of

1984, declined throughout 1986 (see Chart 3). Germany's export volume growth has eroded more gradually, but virtually halted by the end of 1986.

The shifting trends in export and import volumes mean that net foreign trade now is contributing positively to U.S. real GNP growth: indeed, the $12 billion gain in real net exports recorded in the fourth-quarter 1986 GNP accounts provided the entire 1.3% quarter-to-quarter growth in economic activity overall. During 1984-85 and well into 1986, it was the common U.S. lament that an ever-widening trade deficit was bleeding off, to the benefit of foreign rivals, domestic demand growth that might have been met by U.S. firms (see Table 2). This can no longer be said. Instead, the clog now cramps the other foot. Falling real net exports have subtracted from real GNP growth in Japan and Germany since 1985, especially in Japan. Thus despite a sizable increase in Japan's domestic demand during 1986, its fourth-quarter real GNP gain is estimated to have sagged to 1.3%, year on year, compared with an average of 4% annually during the earlier years of the 1980s. In Germany's case, real GNP actually declined during the final quarter of 1986 and its growth was only 2.6% over the course of the year -- hardly different from the pace of 1983-85 and a far cry from the ebullient projections celebrated by most European commentators not long ago.

It is an open question how far these net export swings should be attributed to exchange rate shifts. Domestic demand is a key determinant of both exports and imports, especially the latter. This was clearly the case in 1984, when U.S. domestic demand was roaring ahead and sucked in imports from everywhere. Since 1984, U.S. domestic demand growth has receded greatly, contributing importantly to the moderation of non-oil import growth. Conversely, the step-up in domestic demand growth helps explain recent import growth in both Japan and Germany.

The separate power of the exchange rate factor is more visible in exports. Japan's have been hit much harder than Germany's during the past two years. Although the yen and the mark have appreciated by similar amounts against the dollar, the yen's real effective exchange rate has risen 27%, the mark's just 19%. The difference reflects Japan's closer trade ties with countries whose currencies have weakened. Almost 40% of Japan's total exports went to the United States last year, but only 11% of Germany's. A further 14% of Japan's exports went to the Asian NICs, whose currencies have broadly followed the dollar. Nearly 70% of Germany's 1986 exports went to other European countries, lessening its direct exposure to dollar depreciation.

The protracted weakness of U.S. exports through most of 1986 disguised what would have been a more drastic decline had the dollar remained at its high levels of 1983-85. It need not preclude substantial export gains this year and next. Still, the benefit of dollar depreciation remains unclear: the fact that export volume has begun to rise only in the most recent months suggests a weaker response than generally assumed and one with rather long lags in a sluggish world environment.

Inadequate adjustment assured

The G-5 view of the "fundamentals" does not establish that an acceptable or sustainable international distribution of trade and current account imbalances is in the bag. Although the dollar has fallen from its peak by over 40% against the yen and the mark, the broad index of the dollar that includes 18 industrial- and 22 developing-country currencies shows little more than a 20% inflation-adjusted decline. Moreover, the index remains more than 10% above its 1980 average (see Table 3).

If the dollar remains at current levels indefinitely, Table 4 projects that the $166 billion deficit on the CIF valuation in 1986 should narrow to about $140-$145 billion this year and perhaps as low as $120 billion in 1988. Thereafter, however, the trade deficit would likely begin to widen again. Manufactures trade would suffer eroding U.S. competitiveness as domestic costs outpace those of Japan and Germany. Also, petroleum trade is likely to deteriorate. The 1986 decline in U.S. production, coupled with rising consumption and stockpiling, drove up gross oil imports to 6.6 million bpd, 27% above the 1985 level. The oil import bill could rise $30 billion or more by the end of the decade (see Table 5).

The prospects for the current account are largely dictated by those for the trade account, direct investment income, and net interest payments to foreigners associated with the U.S. shift into debtor status. U.S. net external debt, including direct investment at book value, stood around $260 billion at the beginning of 1987. Direct investment income may show little change this year but, due to the debt buildup, net interest payments of $28 billion could be some $12 billion higher than in 1986. Hence the $20-$25 billion trade improvement may result in no more than a $10 billion reduction in the current account deficit.

Indeed, the current account deficit could begin widening again toward the end of next year. On the optimistic assumption of 5.5% Treasury bill rates, it may approach $160 billion annually by 1990, with net interest payments to foreigners exceeding $40 billion, and the accumulated net debt $840 billion. These figures would run higher if interest rates rise. Moreover, the examples of the United States in 1971, New York City in 1975, and Mexico in 1982 underline that financial market tolerance has its limits, unpredictable though they be, especially if confidence weakens for any reason.

The clear message of this U.S. trade, current account, and debt outlook (and its counterpart implication for the surplus countries) must be that present exchange rates, given existing expectations for U.S. and foreign economic growth, add up to inadequate and probably only transient improvement in the U.S. imbalance.

More substantial and sustained correction will require some combination of a still-lower dollar and a shift in relative economic growth. Historically, a stable dollar has been consistent with a satisfactory U.S. trade balance performance only when domestic demand growth in other industrial countries handily exceeds that in the United States, as in the 1960s. In the 1970s, U.S. and foreign domestic growth were more nearly equal and a depreciating dollar served to shore up the U.S. trade balance. Between 1982 and 1985, U.S. domestic growth outpaced that of other industrial countries by a cumulative 9.5%. The consequences for the U.S. trade balance now could be offset either by sufficient additional dollar depreciation or by undoing and reversing the accrued domestic demand gap. The gap was little changed in 1986 and is projected to shrink only slightly in 1987.

By itself, an increase in foreign economic growth relative to U.S. growth by one percentage point per annum would benefit the U.S. current account by about $25 billion within four years. This sounds less than impressive, given that a 10% depreciation of the dollar would yield a $40 billion benefit. But faster foreign economic growth pays off better when working together with a lower dollar. After all, a lower dollar crimps foreign exports. As Japan and Germany are presently discovering, export weakness ripples through the domestic economy, depressing its growth and import demand. Although proponents of a stable dollar correctly point out that these ripple effects limit U.S. trade improvement, they could be counteracted by steps boosting foreign domestic demand. A successful boost not only can sustain and enhance foreign economies' growth and import demand but also divert foreign exporters to their own domestic markets, curbing their incentive to hang on to U.S. market share at whatever cost. Accordingly, faster foreign economic growth -- or, conversely, lower U.S. growth or recession -- increases the U.S. trade improvement that can be expected from any given degree of dollar depreciation. Table 6 illustrates the magnitudes involved, presenting possible scenarios for the dollar and both U.S. and foreign economic growth consistent with working the U.S. trade and current account deficits distinctly below the $100 billion mark by 1989.

The scenario results give no support to the G-5 endorsement of exchange rate stabilization. If the dollar is held at current levels, meeting the trade target would require holding the U.S. economy in virtual recession while simultanously stepping up foreign growth -- to a pace that seems out of the question amid prevailing perceptions of the politically and economically feasible. Only if the dollar comes down substantially further can the trade target be achieved without forcing a U.S. recession or conjuring up an acceleration of foreign growth beyond the economically practicable. Yet a further drop in the dollar is widely assumed dangerous, and growth-boosting initiatives at best problematic. Given the gravity of the U.S. trade problem, neither assumption should pass unchallenged.

A "free fall" or a "hard-landing"?

Arguments for dollar stability often invoke the specter of a dollar in "free fall," throwing the U.S. and world economies into a "hard landing." Whatever their emotive force, these terms typically go ill-defined and are open to misunderstanding.

The experience of the past two years can be fairly characterized as a "soft landing" adjustment from acute currency misalignment. Despite the dollar's substantial fall, the world has managed a modicum of economic growth and both inflation and nominal interest rates have fallen in the major industrial countries. Long-term interest rates in the key currencies have dropped sharply. Stock markets have soared. Dollar interest-rate differentials against rates in strong currencies have narrowed (see Chart 4).

Interest differentials between currencies reflect anticipated exchange rate movements and risk premiums. In February 1985, at the dollar's peak, interest differentials discounted a dollar decline to DM2.27 and Y168 within ten years (see Table 7). Twelve months later, in February 1986, the corresponding ten-year break-even rates were DM1.81 and Y143. Thus, the dollar has passed the first break-even levels for both the mark and the yen, and for the mark has come close to the second. Obviously, the dollar's decline early this year eclipsed short-term interest differentials.

It is remarkable that the dollar's decline has precipitated no adverse reaction in interest differentials. It has been possible because the dollar's cumulative decline occurred through successive episodes of "free fall," whereby the dollar dropped quite abruptly each time to a new level that did not inspire perceptions of imminent further downward risk. Indeed, this pattern and the cumulative scale and speed of the dollar's decline have done much to facilitate the global soft landing to date.

But the soft landing for the dollar could be transformed into the dreaded "hard landing" of rising U.S. interest rates and recession if, at some unknowable point in the future, investors seek to adjust their portfolios to perceptions of heightened dollar risk. Were the expectation to take hold of a chronically declining dollar -- through official attempts to engineer a "controlled fall" or to stabilize the dollar at a level viewed by the markets as untenable -- interest-rate differentials would be bound to react. U.S. interest rates would likely run substantially higher, and foreign rates only a little lower. The upshot would be the hard landing, a U.S. recession and, in due course, a worldwide downturn. To avoid this worst of outcomes, it is desirable for the dollar to attain a competitive level as soon as possible. The present environment of unresolved trade imbalances and inadequate policy responses by the major economies render any attempt to stabilize the dollar now distinctly premature.

Inflation worries

An upsurge in U.S. inflation is among the dangers most often imputed to a further dollar decline. Some will point to January's 8% annualized inflation rate in the consumer price index (CPI), and upturn in interest rates, as proof that inflation already is taking off. Fortunately, there are weighty reasons to deem the January inflation figure an aberration. The global economy has been disinflating throughout the 1980s. In 1986, the fourth year of recovery, the rise in the GNP deflator for all industrial countries was 3.5% in local-currency terms, down from 4.2% in 1985. The U.S. deflator decelerated from 3.4% to 2.6%. Real interest rates remained high in all major countries. They actually rose in some (see Chart 5), and in the United States continue at inflation-restraining levels. Demand pressure is slight on available production capacity in industrial countries generally, including the United States: since the last cyclical peak, at the beginning of 1981, OECD industrial production has risen a slim 2% annually on average; real GNP growth has been 2.5%, well below the 3% or higher growth of output potential. The growth surge widely projected after oil prices collapsed a year ago never developed, the price stimulus to demand being offset by restrictive economic policies and unexpectedly high consumer savings in Japan and Europe. In fact, OECD real GNP grew 2.5% last year -- below the 3% growth in 1985.

U.S. real GNP growth has held around 2.5% per annum for the past two and a half years. U.S. industrial production, which has only recently perked up, has advanced little more than 3% above the mid-1984 level. U.S. manufacturing is most recently reported operating at just under 80% of capacity, down from 82.8% in the summer of 1984 and well below the level traditionally associated with the outbreak of demand-pull inflation. In fact, it is singularly hard to identify instances of bottleneck in the U.S. economy at present. The CPI rose 1.5% over the past twelve months (see Table 8). The index was depressed by the fall in energy prices during the first half of 1986 and was pushed up by their recovery during the second. Excluding erratic food and energy prices, there is little sign that inflation is accelerating above the 3.5%-4.5% range that elicited broad satisfaction before oil prices crumbled.

Although the 1986 rise in gold prices was bound to set inflation tongues wagging,* commodity prices in general show no great buoyancy. Food prices have continued their long-standing erosion. Although industrial commodity prices climbed markedly during the last months of 1986, they have stabilized in recent weeks and are far below their early-1980s peaks. The recent run-up in oil prices stemmed primarily from stiffening OPEC pricing and production discipline. However, stabilization around $18 per barrel still remains only a goal, not an accomplished fact. In all, given the dollar's depreciation since 1985, the major conclusion from commodity prices must be that the global excess of capacity and production over demand is more profound than virtually all analysts have conceived.

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*The gold price soared from $325 per ounce at the end of 1985 to the $420-$430 range last October, reflecting Japanese buying for special commemorative coinage and the dollar's decline (in mark or yen terms the price upturn has been modest). Partly on the prospect of increasing supply from new projects in a number of countries, the price in real terms now stands 60% below its 1980 highs.

U.S. non-oil import prices accelerated considerably during 1986 but their 6% cumulative rise from their 1985 lows has been far short of the dollar's depreciation. Thus the "pass-through" of dollar depreciation into U.S. import prices has been both tardy and incomplete. Several reasons may be cited. First is the time lag between contract and delivery. Second, lacking robust alternative export or domestic markets and unwilling to give up U.S. market share, foreign exporters often have chosen to let their formerly fat U.S. profit margins take the strain of the dollar's fall. Third, U.S. producers are switching their outside sourcing from areas disadvantaged by the dollar's fall -- principally, Japan and continental Europe -- in favor of the Asian NICs and the like, or, in what may prove a gathering trend, to U.S. locations. Exchange rate pass-through will remain incomplete for the foreseeable future. However, it will increase as imports recently contracted are actually delivered, as is inevitable and also desirable, because currency depreciation can yield its full benefits only if relative prices adjust decisively. Now that import profit margins are much compressed, it can be expected that any further dollar depreciation will pass through more fully than the depreciation to date.

The outlook for the general U.S. price level hinges on domestic price response to import prices and the concurrent behavior of "domestically generated" inflation. Now that non-oil imports amount to 8% of GNP, compared with 6% in 1980 and 5% ten years earlier, a tighter link may be developing between domestic and import pricing. But at present, however tight the link may be in certain sectors, it still appears loose for U.S. industry as a whole. Thus, despite the acceleration in non-oil import prices, U.S. producer prices, excluding food and energy, remain subdued: intermediate goods prices are up just 0.6% over the past twelve months; finished goods prices are up some 2.8%, concentrated in the automobile industry.

At the consumer level, goods prices generally, even excluding energy, must be characterized as soft. Most encouraging, the 4.2% 1986 increase in services prices was the lowest since the recession year of 1982 and dramatically below the 1980 peak rate of over 14%. Moreover, since many services are not exposed to international competition, they feel little upward price pressure from the dollar's fall. Services dominate goods in U.S. economic life, as is recognized in the newly revised CPI, and their pricing imparts substantial inertia to consumer prices overall.

Of course, whatever the general picture, some prices show sizable increases. Often these represent no more than a relative price level correction, responding to sectoral cyclical recovery or external pressure associated with the dollar's decline. In other cases, rising prices correspond to long-established inflationary proclivities, such as in health care, where market discipline is weak, and in automobiles, where protection from imports has underwritten engrained habits and the domestic producers evidence little stomach for the effort to reclaim home-market share.

Wage behavior provides the most persuasive evidence that U.S. inflation will remain well contained on the whole for some time to come. Although no one can be happy with trends in U.S. labor productivity -- witness the first estimates for 1986, which show a rise of just 0.7% economywide and 2.7% in manufacturing -- labor costs, by and large, are not generating a major push on total costs. Gains in adjusted hourly earnings continue on a modestly downward trend (see Chart 6). Standard explanations stress the decline in union power and representation; deregulation in such fields as transport, telecommunications, and finance; and the spread of flexible work practices, especially through contracted-out and part-time employment.

While the dollar was rising, its strength was seen as a direct discipline on U.S. wage behavior and profit margins. Despite the dollar's now two-year-old slide, the discipline lives on. Consciousness of global competition has taken hold among U.S. management and labor. It will remain potent as long as import penetration remains anywhere near present levels.

Can sustained U.S. wage moderation be taken for granted? One worry comes if protection from imports becomes too readily available: formal and informal protection of the U.S. automobile industry during the 1980s seems to have held back productivity improvement and has sustained wages at uncompetitive levels, as has been true for a much longer period in steel. A second concern stems from the celebrated success of the U.S. economy in job creation. At 6.7%, the U.S. unemployment rate now lies within the zone of contention as to just where the U.S. NAIRU -- the non-accelerating inflation rate of unemployment -- now stands. The 1970s' experience encouraged the pessimistic view that the U.S. NAIRU had risen to 7%. Recent evidence, principally associated with a more experienced and skilled labor force, suggests the rate has fallen in the 1980s, to 6% or even 4.5% by OECD estimates.

It would be rash to expand U.S. economic activity so much as to mop up all unemployment above the most favorable reading of the NAIRU. The inflationary risk would be all the greater if other industrial countries were

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simultaneously to boost their own economic growth. Near-term goals for U.S. real GNP growth therefore should not be pressed materially above the 2.5% pace that has proven consistent with both a gradual fall in unemployment and continuing wage moderation. Provided this moderation is maintained, the relative price adjustments essential to a competitive U.S. position in world trade can be completed with only temporary upward pressure on U.S. inflation.

The twin U.S. deficits and economic growth

Anxieties about an inflationary hard landing may underlie the U.S. Administration's apparent acceptance that the dollar should be stabilized. From here on, it seems, boosting national competitiveness in the sense of productivity growth and reducing the federal budget deficit are to form the U.S. contribution to global international adjustment. Stepped-up U.S. productivity growth is obviously in the interest of improving long-term living standards and could mitigate the pain of trade adjustment. But there should be no illusion that productivity growth will of itself work quick miracles for the trade balance.

In fiscal policy, there is little doubt that the U.S. posture has already assumed a restrictive course. The federal deficit for the first four months of the current fiscal year came in $40 billion less, at an annual rate, than in the year-earlier period. A fairly conservative assessment of budgetary actions already in place or in the works would put the likely 1987 calendar-year deficit at $170 billion, 3.8% of GNP and a full percentage point below last year's.

The fiscal implications for the U.S. trade deficit are less certain, contrary to the widespread catechism of one-to-one connection. The catechism flows from the accounting identity that the current account surplus or deficit equals the excess or deficiency of domestic private and public saving relative to domestic investment. Reduced public dissaving through budget deficit reduction therefore shrinks a current account deficit, provided the balance of domestic private saving and investment remains unchanged.

Nonetheless the self-evident relationship so often asserted turns out anything but simple and predictable in practice -- and is not at all guaranteed to be positive. The fiscal balance is not the sole arbiter of the external balance, nor should it be overlooked that the fiscal posture exerts powerful influence on economic activity generally and saving and investment specifically -- and thereby on economic growth. Of course, saving, investment, and growth also are affected by domestic monetary policy, both monetary and fiscal policies abroad, and events that may be beyond policy control, such as terms of trade shocks and, to a major extent, exchange rate movements. Accordingly, if fiscal contraction is to succeed in reducing a current account deficit without depressing economic growth, there must be an offset from other macroeconomic policies either at home or abroad. The appropriate degree of domestic monetary relaxation will be contingent on foreign macroeconomic policies and performance. Adjustment of policies abroad may have much to contribute to a mutually constructive, growth-promoting resolution of international imbalances.

The complexities in the link between budget and current account adjustment are richly evident in both U.S. and foreign experience. Over the 1979-1986 period, as link enthusiasts are quick to emphasize, the U.S. fiscal and current account balances each shifted sharply into deficit, by some 4% of GNP. But Chart 7 demonstrates that the one-to-one, positive U.S. association over this period was only rarely replicated elsewhere in the industrial world. True, Japan and Germany fall near the dashed line in the chart, expressing approximate one-to-one linkage. But in several cases -- Belgium, the Netherlands, and Spain, for example -- fiscal and current account changes were negatively associated. In Greece, a widening of the fiscal deficit by over 11% of GNP left the current account balance completely unaffected. Ireland's current account strengthened by over 12% of GNP, with practically no fiscal improvement. Furthermore, as the chart shows by selected examples from the 1970s, for a number of countries -- including the United States -- the direction of fiscal/external balance association has been unstable.

Looking more closely at past U.S. experience, in 1975 the current account attained a record surplus in terms of GNP (see Table 9), not least because of the steep, post-oil-shock recession and correspondingly low import demand. Yet the general government budget deficit -- which covers federal, state, and local results -- ballooned to over 4% of GNP. U.S. fiscal policy then was tightened: the cyclically adjusted budget balance moved toward surplus by 1% of GNP in 1976 and cumulatively by almost 3% through 1978. Despite the fiscal tightening, U.S. economic activity and income growth recovered and the current account deteriorated in 1977-78 to what were then record deficits.

The explanation for this episode of negative linkage between U.S. fiscal and current account trends lies principally in the Federal Reserve's monetary policy, which turned unintentionally easy toward the end of Arthur Burns' tenure. Although nominal interest rates rose, giving the appearance of a tight monetary posture, real interest rates were negative from 1976 through late 1978. Total domestic saving increased, thanks to rising incomes in the private sector and deficit reduction in the public sector. But total demand on U.S. capacity grew rapidly, especially from domestic sources, with the result that domestic investment increased even faster than saving. Imports rose strongly, but exports less so because of the relatively slow growth of domestic demand in other industrial countries.

Thus, a shortfall in foreign growth worked to compound a U.S. fiscal/external linkage that already was negative for reasons of domestic monetary policy. Had the latter been less accommodative, lower domestic investment growth would likely have engendered better current account performance, accompanied by lower inflation and a stronger dollar -- but lower real GNP. Tighter monetary policy would have been amply justified in 1978, when capacity utilization hit 87.5% (as noted earlier, it is under 80% today). In the event, decisive monetary restraint was deferred until 1979. In conjunction with a weaker dollar and a pickup in foreign economic growth, this monetary restraint produced a current account surplus by 1980 -- and without fiscal contraction.

Italy's 1974-78 experience likewise merits recall. Although its budget and current account balances moved in the same direction at times, for the period as a whole they moved oppositely. In 1974 the lira became overvalued. The current account deficit shot up to 4.7% of GDP in response to rapid economic growth, exploding wages, and the run-up of oil and other commodity prices -- yet the budget deficit increased hardly at all. At creditors' insistence, Italy's short-term interest rates were raised to over 20% in June 1974 and taxes by 2.5% of GNP soon after. In 1975 the levels of real GDP plummeted by 3.5% and industrial production by over 9%, inflation halved by midyear, and the current account deficit almost disappeared. But the fiscal/external link turned out negative. Contrary to the current account improvement, the budget deficit rose from 7% of GDP in 1974 to 11.7% in 1975, reflecting both recession and the deliberate fiscal expansion undertaken that August. This expansion helped precipitate another exchange crisis in January 1976. Both monetary and fiscal restraint were reapplied and the current account swung into surplus in 1977-78. This time, the fiscal/external link turned out positive, but there was strong simultaneous support from monetary policy, a sharp depreciation of the lira, and quickening economic growth in export markets.

Although Japan's post-1979 experience suggests a one-for-one positive association between fiscal restraint and current account improvement, it also demonstrates the critical importance of external factors. Between 1979 and 1986, Japan's cyclically adjusted budget balance contracted by 4% of GNP and the current account soared into outsize surplus. Net export strength allowed Japan's real GNP growth to exceed that of domestic demand for seven consecutive years. From early-1983 through mid-1985, exports to the United States accounted for an astonishing 40% plus of Japan's real GNP growth, rocketing over 100% in real terms. More recently, with the slowdown in U.S. demand and a stronger yen both hitting exports, Japan is feeling the negative consequences of fiscal restriction full force. Present budget policies point to a further fiscal contraction this year, by a cyclically adjusted 0.6% of GNP -- despite ever-weakening growth prospects. Unless a large supplementary budget is swiftly enacted, or Japan's export markets grow unexpectedly fast, 1987 is likely to see a further reduction in the budget deficit in conjunction with a diminished external surplus -- a negative link.

In assessing the value of fiscal restraint for tackling today's U.S. external imbalance, it is vital to digest the lessons from the U.S., Italian, and Japanese experiences just cited. These make clear that external factors and domestic monetary policy are crucial in determining not only the current account payoff from fiscal restraint but also its cost in terms of economic growth. The external factors facing the United States are less than propitious. Barring major policy changes abroad, of which the G-5 communique provides scant promise, real GNP growth in other industrial economies is likely to remain anemic. The dollar's depreciation to date should shore up U.S. global market share somewhat. But, in view of its concern about further dollar erosion, the Federal Reserve cannot be relied upon to ease monetary policy and offset the recessionary implications of fiscal tightening. In all, even if U.S. fiscal restraint helps narrow the trade deficit, it is an open question whether this will occur without detriment to U.S. and global economic growth.

G-5 at sixes and sevens?

The G-5's February pronouncement merits support in two important particulars: the recognition that international trade imbalances pose serious risks; and the judgment that exchange market stability will be a product of supportive fundamentals, not central bank intervention or target zones.

But the G-5 revealed itself at sixes and sevens in the matter of Canadian and Italian participation and, more importantly, in its professed view of the fundamentals -- that actions to date and promised have already brought the fundamentals sufficiently into place to warrant exchange market stability around current levels for the major currencies. With world economic growth stumbling and LDC financing issues once again on the boil, complacency is not in order. Premature dollar stabilization could risk higher U.S. interest rates, U.S. recession, and renewed world deflation. This describes the hard landing that everyone hopes to avert, not the maintenance of the soft landing that is so clearly in the general interest.

Of course, it is tempting to procrastinate. The ease of financing the U.S. current account deficit so far -- thanks to a world of integrated capital markets, ample liquidity, and an abundance of savings seeking attractive investment outlets -- suggests the deficit can be financed for quite some time ahead. In addition, more rapid adjustment could harm those many countries -- Japan, Korea, and Taiwan, to name but a few -- that have relied excessively on exports to the United States for economic growth at home; even some U.S. exporters are worrying about an eroding ability of foreign customers to purchase U.S.

products. Besides, it will be said that the United States has more certain or better ways than dollar depreciation to tackle the trade deficit: for example, by protectionist trade legislation, measures to strengthen productivity and competitiveness, and -- most of all, to many minds -- by fiscal rectitude. Yet, U.S. actions alone, as the body of this article has demonstrated, are unlikely to yield a swift and adequate result, and indeed risk the opposite.

Since international imbalances are every bit as dangerous as the Group admits, they need to be tackled as a matter of *urgency*. Concrete policy changes are required of a kind and degree that offer convincing promise of accomplishing a satisfactory resolution of the imbalances, not merely their token alleviation. Thus the U.S. trade deficit needs not just to be steered onto a declining trend but to be cut back by $100 billion per annum, with commensurate implications for the surplus countries. No commitment to prompt policy changes adequate to this end is to be found in the G-5 communique, nor in more recent official policy expositions.

The U.S. trade deficit is an intrinsically *international* issue. Not only is the scale of the problem beyond the unaided grasp of even the world's number one economy, but also the problem originates less in expansionary U.S. policies than in lagging growth in other industrial economies, biased growth in the Asian NICs, prolonged currency misalignment, and the LDC debt problem.

A balanced international approach recognizes these multiple sources of the U.S. trade problem and urges steps to tackle all, without disproportionate weight on any single target. As is by now familiar, such an international approach looks to contributions from the United States, in the form of fiscal restraint; from other industrial countries and the Asian NICs, through expansionary domestic policies; and from exchange rate adjustment to handle that major part of the job that cannot sensibly be accomplished by twisting the differential between U.S. and foreign economic growth. Regrettably, after two years of fruitless prodding of Japan and Germany to put aside their mercantilist or nationalist traditions and come to terms with their growth and adjustment responsibilities, it becomes questionable whether much good will come of efforts to coordinate international action.

While not abandoning the international approach, the United States should now move ahead forcefully on its own. First, productivity and competitiveness initiatives, including efforts to open up export markets abroad, may have much to commend them for alleviating the stress on domestic living standards inherent in trade deficit correction and for strengthening long-term U.S. economic performance generally. But, as with protectionism, the near-term benefit for U.S. trade would be marginal since the imbalance is fundamentally a macroeconomic phenomenon. Second, on the fiscal front, the United States should stick to the gradualist profile now in the works for federal deficit reduction, buying genuine spending restraint with modest consumer imposts on such items as alcohol and tobacco, and perhaps also on energy, totaling $10-$20 billion. Third, to alleviate the contractionary fiscal influence on U.S economic growth, Federal Reserve policy should provide positive offset. The risk that careful monetary easing will unleash inflation is a lesser concern than that of inadequate economic growth and trade adjustment. As the U.S. policy mix shifts, the dollar is likely to fall, ideally by up to 15% on the broad effective index.* This should not be resisted but welcomed as a tool to force more adequate U.S. trade and current account adjustment. The extra dose of dollar depreciation would erode the exports of surplus countries and demonstrate, through reality rather than exhortation, that their domestic policies need overhaul. The more they ultimately beef up their domestic growth, the less their currencies will need to rise.

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*A decline of this magnitude cannot be accomplished solely by pressuring the Asian NICs and Canada to revalue on the grounds that their currencies have barely participated in the overall adjustment of the dollar so far and, in the case of the NICs, that they are running huge current account surpluses. Even if, at the extreme, one hypothesizes revaluations against the dollar of 40% for the NICs' currencies and 8% for the Canadian unit, the yen and the European currencies still would need to rise 10% or more. It should be noted that the dollar remains above the levels of Y130 and DM1.55 that would replicate today the purchasing power relationships that prevailed in the fall of 1978. Moreover, since U.S. inflation is projected to run higher over the next few years than in Japan and Germany, further nominal dollar depreciation will be needed just to maintain the present level of U.S. competitiveness.

In sum, the United States needs to be crystal clear, both to itself and to trade partners, about one of its most urgent national objectives: to bring down its trade deficit by at least $100 billion before the end of this decade, with minimal resort to protectionism and without precipitating recession at home or abroad. At this stage, when the requisite adjustments are not yet in hand will, any form of currency stabilization distracts from the fundamental objective. Clarity and determination on these points should help preserve confidence and improve the chances that the necessary further fall in the dollar will save the economy from a hard landing. By contrast, obfuscation and procrastination can only undermine confidence. Worse, they heighten the risks that the world economy will fall victim to the resurgent tide of protectionistic nationalism now evident in Japan, Europe, and a number of the LDCs -- and, not least, in the United States itself.

Table 1

U.S. bilateral trade balances
FAS/CIF valuation
billions of dollars at annual rates,
not seasonally adjusted

		3 months ended Jan 1987	
	1986	Actual	Change from year earlier
Japan	-58.6	-62.9	-4.4
Canada*	-23.3	-22.5	3.3
Western Europe	-32.3	-33.8	2.1
Germany	-15.6	-15.5	0.1
France	-3.4	-3.7	0.8
United Kingdom	-4.6	-5.9	0.4
Italy	-6.5	-5.8	1.1
Netherlands	3.5	4.1	1.2
Latin America	-13.6	-13.5	7.3
Brazil	-3.5	-3.1	0.8
Mexico	-5.2	-5.8	1.2
OPEC**	-4.6	-4.2	3.3
Asia excluding Japan	-37.4	-41.3	-5.8
Hong Kong	-7.1	-7.7	-2.1
Korea	-15.7	-17.3	-4.8
Singapore	-6.4	-7.5	-0.8
Taiwan	-1.5	-2.2	-0.7
Other countries	0.0	-0.4	-3.4
Total preliminary	-169.8	-178.6	2.4
Total revised	-166.3		

*According to Canadian data, U.S. customs statistics understated U.S. exports to Canada by $12 billion in 1986. Annual bilateral reconciliations normally resolve this discrepancy largely in favor of the Canadian data and lead to eventual revision of the U.S. balance of payments basis trade statistics.

**Excluding Ecuador, Indonesia, and Venezuela.

Table 2

Real GNP
percent change, seasonally adjusted annual rates

	1982Q3- 1984Q2	1984Q2- 1985Q4	1985Q4- 1986Q4
United States total	5.9	2.6	2.1
Domestic*	7.7	3.5	2.6
Foreign*	-1.8	-0.9	-0.5
Japan total	4.2	4.6	1.3
Domestic*	2.6	3.9	3.1
Foreign*	1.6	0.7	-1.8
Germany total	2.1	3.1	2.6
Domestic*	1.7	2.4	3.3
Foreign*	0.4	0.7	-0.7

*Contribution as percent of beginning period GNP.

Table 3

Dollar exchange rates
units per dollar, except as noted

		% change in dollar since	
	Feb 27, 1987	Feb 85 (avg)	1980 (avg)
Nominal effective, traditional*	96.7	-29.1	6.6
Real effective*			
Traditional	92.6	-29.9	3.0
Broad	101.2	-23.0	11.8
Dollar vis a vis			
Japanese yen	153	-41.0	-32.5
German mark	1.83	-44.4	0.7
French franc	6.08	-39.6	43.9
British pound	1.55**	-41.0	50.3
Italian lira	1299	-36.0	51.7
Canadian dollar	1.35	-1.4	15.5

*1980-82=100; traditional: dollar against currencies of 15 other industrial countries; broad: dollar against currencies of 18 other industrial countries and 22 developing countries.

**Dollars per pound.

Table 4

U.S. current account outlook
in billions of dollars, on present economic growth prospects and with no further dollar depreciation

	1986	1987	1988	1990
U.S. current account	-145	-135	-120	-157
Trade balance (CIF)	-166	-145	-120	-165
Net investment income	16	4	-5	-6
Direct investment	32	32	35	38
Interest	-16	-28	-40	-44
Other invisibles	5	6	5	2
Net foreign debt, year end*	257	400	530	843

*The net investment position of the United States with sign reversed. This projection assumes that the net equity position of the United States remains unchanged from end-1985 levels and that the counterpart of the current account deficit is a buildup of interest-paying U.S. liabilities abroad.

Table 5

U.S. oil demand and supply
millions of bpd, except as noted

	Average 1980-81	1985	1986	1990
Consumption	16.6	15.7	16.2	16.9
Production	-10.2	-10.6	-10.3	-9.3
Other domestic supply*	-0.6	-0.7	-0.8	-0.8
Stock change	0.0	-0.1	0.2	0.0
Net imports	5.9	4.3	5.3	6.9
As percent of consumption	36	27	33	42
Gross imports**	6.6	5.2	6.6	8.3
Average price, FOB (dollars per barrel)	32.8	26.6	14.6	22.0
Value (billions of dollars)	78.5	50.5	35.3	66.6

*Processing gain and unaccounted oil.
**Balance of payments basis.

Table 6

Adjustment choices: combinations of economic growth and exchange rates that will reduce the U.S. trade deficit, CIF, below $100 billion in 1989

Exchange rates, end-1988				
Yen/$	154	154	125	125
DM/$	1.85	1.85	1.60	1.60
Real GNP growth % per annum, 1987-89				
Japan	5.4	6.3	4.3	5.5
Germany	5.4	5.7	3.4	5.0
United States	1.0	2.0	2.0	3.0

Table 7

Break-even exchange rates

	One year	Three years	Ten years
Government bond yields by maturity, percent per annum			
February 28, 1985			
United States	9.73	11.02	11.92
Germany	6.73	7.03	7.67
Japan	6.65	6.84	7.16
February 27, 1986			
United States	7.46	7.81	8.14
Germany	4.37	5.06	5.92
Japan	5.35	5.46	5.63
February 26, 1987			
United States	5.87	6.52	7.20
Germany	3.98	4.75	6.10
Japan	4.13	4.32	4.96
Implied break-even exchange rates			
February 28, 1985			
DM/$ (spot 3.34)	3.25	2.99	2.27
Yen/$ (spot 259)	252	231	168
February 27, 1986			
DM/$ (spot 2.2)	2.17	2.10	1.81
Yen/$ (spot 180)	177	169	143
February 26, 1987			
DM/$ (spot 1.83)	1.79	1.74	1.65
Yen/$ (spot 153)	151	144	124

Table 8

U.S. inflation
selected indices, annual rate percent changes*

	Latest 12 months	Latest 6 months	Latest 3 months*
GNP deflator			
Implicit	2.6	2.4	0.5
Fixed weight	2.7	2.3	2.7
Non-oil imports	3.3	5.6	8.3
Consumer prices	1.5	3.5	4.4
Excluding food and energy	3.8	4.0	4.2
Goods	-1.3	3.1	4.9
Excluding food and energy	1.4	2.4	3.2
Services	4.3	4.0	4.3
Excluding food and energy	5.1	4.9	4.7
Producer prices			
Finished goods	-1.5	0.7	2.9
Excluding food and energy	2.8	2.7	3.7
Intermediate goods	-3.2	-1.9	1.0
Excluding food and energy	0.6	0.9	1.7
Commodity prices**	-9.2	8.1	12.7
Food	-9.1	-6.0	-3.2
Industrials	-5.9	9.0	26.8
Gold	16.6	32.5	-14.9

*Data are through January 1987, except for commodity prices (February) and the GNP deflators (1986 Q4).

**Commodity Research Bureau.

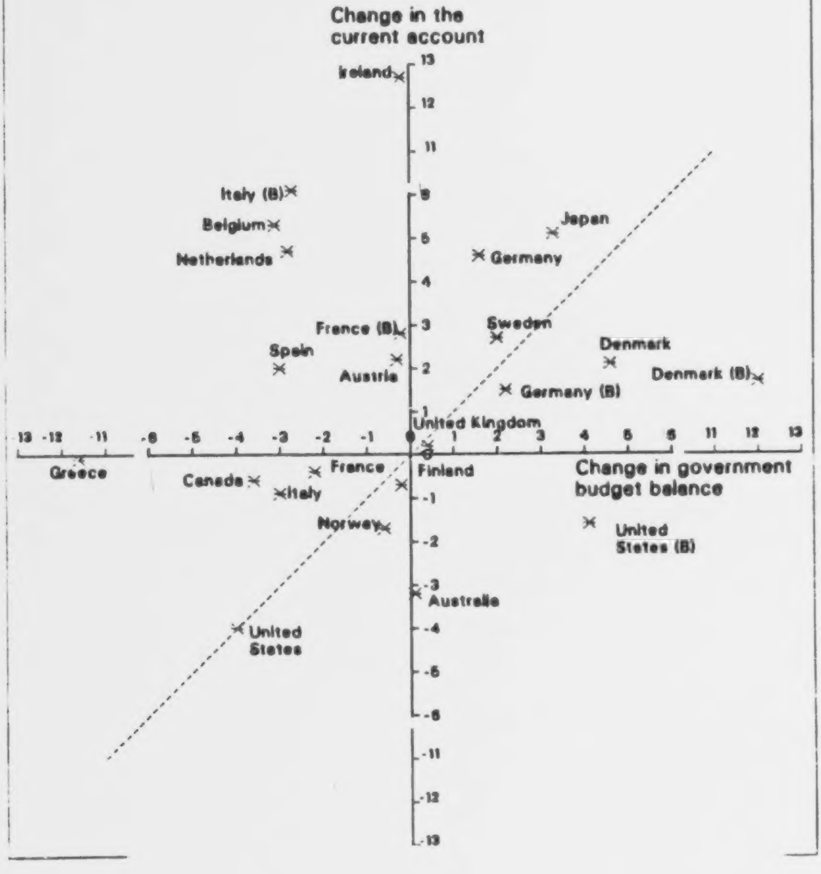
Table 9

Saving, investment, and current account
percent of GNP/GDP

	Current account	Domestic saving		Domestic investment
		Total	Budget balance	
United States				
1975	1.1	14.9	-4.1	13.7
1978	-0.5	18.2	-0.0	18.6
Italy				
1974	-4.6	21.9	-7.0	26.6
1978	2.4	22.4	-9.7	20.0
Japan				
1979	-0.9	31.5	-4.8	32.5
1986*	4.4	32.1	-1.5	27.7

*Estimated.

Budget and current account balances
*as percent of GNP, 1979-86**



STATEMENT OF

KENNETH T. BLAYLOCK
NATIONAL PRESIDENT
AMERICAN FEDERATION OF GOVERNMENT EMPLOYEES
(AFL-CIO)

TO THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

ON

THE ADMINISTRATION'S FY 1988 BUDGET PROPOSAL

ON

MARCH 4, 1987

My name is Kenneth T. Blaylock. I am the National President of the American Federation of Government Employees (AFL-CIO), which represents over 700,000 active and retired government workers. I am pleased to submit this statement on the President's FY 1988 budget proposal.

We have been coming before this Congress for each of the last six years to testify on this Administration's budget. Each year we see similar, and often identical, proposals to: increase spending on military hardware, cut spending on social services, increase user fees, sell government assets, and neglect major revenue sources. Each year, we see more of the smoke and mirrors of delusionary economic assumptions. Each year, labor unions and their allies oppose such proposals. And each year Congress is left with the task, abdicated by the President, to construct a responsible budget.

But each year we tend to lose some of our sense of outrage over this document. Now political pundits are even to the point of pronouncing the budget DOA--dead on arrival--thus making it so much easier to ignore the content of this budget and the statement it makes about the priorities this Administration has for this country.

Each year the reactions seem more muted and restrained and the analysis more perfunctory. It is different for government employees. We work in these programs. We make them function. We know what they mean to the American public. And from this perspective, we are outraged by this budget.

We are outraged that Legal Services Corporation, Urban Development Action Grants, the Economic Development Administration, and Section 202 Elderly and Handicapped Housing would be terminated while spending on Star Wars goes up 66 percent.

We are outraged that (according to the Center on Budget and Policy priorities) one-third of the programatic spending reductions would occur in low income programs when such programs constitute only one-ninth of the federal budget.

We are outraged that the farmers, students, and Medicare recipients are the losers in this budget, while defense contractors and oil companies are the winners.

We are outraged that the Administration endorses Gramm-Rudman-Hollings and a freeze on tax revenues, then weasels out of the hard choices by using pie in the sky economic assumptions which "wish away" 26.6 billion dollars of the deficit (according to the Congressional Budget Office).

We are outraged that the Administration portrays one-time asset and loan sales which reduce future revenues as an answer to the deficit.

We are outraged that the Administration recycles proposals which Congress has thoroughly examined and rejected and portrays them as serious proposals.

Of course, outrage is not enough to construct a serious budget resolution. There are very few easy choices. The driving force behind the difficult choices is the large $173 billion budget deficit.

The outlines of the solution are widely recognized: restraint in the weapons buildup, repeal of the Gramm-Rudman deadlines, and additional revenues. The revenue proposal by House Speaker Jim Wright (D-TX) is an eminently reasonable first step to knock off 30 billion dollars a year from the deficit.

Speaker Wright's proposal, in its essence, is: no more tax cuts for the rich.

Last year's tax bill cut the top individual income tax rate from 50 percent to 38.5 percent this year. Next year the top rate is scheduled to drop again to 28 percent. The Speaker would simply do away with the scheduled reduction. This proposal would not affect the average family. For over 85 percent of families, the 1986 tax cuts are already in place. By far, the largest impact would fall on people with incomes over $100,000. These people, who got the biggest share of the 1981 tax cuts, can manage without their scheduled 1988 tax cut.

FEDERAL EMPLOYEES AND THE BUDGET

The FY 1988 budget for federal employees recycles proposals to cut health insurance, cap pay, and reduce Civil Service Retirement.

PAY

The federal pay systems are in total disarray. Special rates are proliferating. There are an increasing number of legislative proposals to "patch up" particular problems. Turnover is increasing. Quality recruits to the federal service is down.

Pay for federal employees has been caught between an antagonistic Administration and budget deficits. As a result, federal pay has fallen behind in virtually every relevant comparison.

o According to the Federal Pay Comparability Act of 1970, federal wages are to be set by wages for similar positions in the private sector. By that standard, according to the 1986 Annual Report by the President's Pay Agent, federal wages would require an upward average adjustment of 20.8 percent. (This includes the three percent 1987 January pay raise). This ranges from a low of 19.2 percent for GS-7 to a high of 26 percent for GS-15.

o Federal employees over the Reagan Administration have seen their real wages (adjusted for inflation) fall by 10.7 percent.

o Postal wages have increased 32.4 percent from 1980-1986, compared to 22.0 percent for federal workers.

o Employee compensation for state and local government employees has increased 32.2 percent from 1981-1986 as measured by the Employee Cost Index (ECI) (1980 data unavailable). This compares to a 16.4 percent pay increase for federal employees over the same period.

o Private sector salary and wage increases (as measured by the ECI) have gone up 33.3 percent compared to a 22.0 percent pay increase for federal employees from 1980-1986.

o According to a recent General Accounting Office (GAO) report (June, 1986) comparing employees entering the military and civilian service with comparable educational background, the average military cash compensation is 15 percent over that of civilian cash compensation. Adding benefits to the calculation results in military total compensation besting civilian compensation by 27 percent. Yet the President is proposing a military pay raise of 4 percent for FY 1988-- twice that proposed for civilians.

The pay crisis manifests itself in every agency. For example, AFGE's Council of Prison Locals reports that of six prisons surveyed, 54 percent of the officers in those prisons had less than two years experience. Prisons are always dangerous places, but this type of staffing makes them even more dangerous.

The Quadrennial Commission made a strong case for the need for higher pay for federal executives. But federal executive pay is only the tip of the iceberg. Good managers can only succeed if they have good workers, and to recruit and retain good workers you have to compensate them fairly.

We recognize that a full-scale reform is on the agenda. We welcome the opportunity to reassess the entire pay and classification system in the federal sector. But there should be no illusions that any such reform can succeed without additional pay. Any zero-sum solution (like some merit pay proposals) seeking to pay selected groups of workers more by lowering the pay of other workers is doomed to failure.

AFGE remains convinced that the comparability principle is the soundest method for adjusting pay other than full-scale collective bargaining. Comparability, if adhered to, depoliticizes federal pay. Both taxpayers and federal employees are assured that government salaries are the same as similar jobs in the private sector. Comparability is a market-based system. It has been endorsed by virtually every formal body from the Rockefeller Commission to the GAO, which has investigated federal compensation.

AFGE fully recognized that retirement and other benefits are simply a part of a compensation package which includes pay. Comparability needs to be defined in such a way so as to include such benefits (total compensation).

The respected Washington research firm Hay/Huggins Company has been comparing federal employee total compensation to relevant private sector employee total compensation. In March of last year, the Hay/Huggins Company reported that total federal compensation lags the private sector by 15.7 percent.

Given private sector compensation increases (about three percent in recent years), federal employees would require three years of seven percent wage increases to achieve comparability based on total compensation. (Such a three-year catchup has precedent. In the 1960's, when federal compensation fell behind the private sector, Congress used a three-year period, 1967-69, to address the imbalance.)

Federal workers should be granted a seven percent wage increase for FY 1988 to begin this process.

Retirement

The Administration has proposed to permanently alter the Civil Service Retirement System (CSRS) Cost of Living Adjustment (COLA) to the increase in the Consumer Price Index (CPI) minus one percent. Congress addressed this issue last year. First, the House passed H.R.460, sponsored by Mary Rose Oakar, which guaranteed federal retirees a full COLA. Then, the Senate attached a similar amendment, sponsored by Slade Gorton (R-WA), to last year's Continuing Resolution.

The Administration justifies the CPI minus one COLA by pointing to the new Federal Employee Retirement System (FERS). This is disingenious. The FERS is a radically different retirement system compared to CSRS. Some provisions, like the thrift plan, are superior to CSRS. Others, like the COLA, are inferior. Singling out an inferior provision as a rationale for lowering the CSRS provisions is meaningless.

The COLA does nothing but protect civil service retirees from having their real income eaten away by inflation. Although a one percent COLA reduction does not sound like a significant cut, retirees who lived 40 years after retirement would see their real income slashed by 32.1 percent.

The Administration also seeks to eliminate the so-called lump sum option, which was included in the recently-passed FERS legislation. Employees, upon retirement, can choose to receive an amount equal to their retirement contribution and have their pension reduced accordingly (an actuarial reduction). Although the lump sum option has short-term budget costs, the provision has no long-term costs. (Initial outlays for the lump sum are totally offset by lower pension outlays in the future.) Yet, an employee is granted considerable flexibility in making retirement plans. It would be a travesty if federal retirees were denied this attractive option solely for the appearance of short-term budgetary savings which would be totally wiped out by larger outlays in the future.

Health Benefits

The Administration seeks to lower the government's contribution to Federal Employee Health Benefits (FEHB) program by basing its contribution on all plans instead of the "top" six. This is not a new proposal. The bottom line of this proposal is that employees would be faced with higher health insurance costs or forced to choose an inferior health insurance package.

The absurdity of this proposal is highlighted by the recent GAO study (GAO, HRD-87-32BR) which compared health insurance coverage for federal and private sector employees. Their six-year comparison showed that federal enrollees pay more of their health care costs in premiums, deductibles, and co-insurance than do enrollees in the private sector. Only 39 percent of private sector enrollees paid part of their premiums. All federal employees were subject to deductibles of $150 or more, compared to only 20 percent of private sector enrollees in 1985.

This GAO study confirms the results of the Mercer study which was commissioned by the House Post Office and Civil Service Committee in 1982. We expect the Congress to totally reject the proposals on FEHB.

Staffing

The Administration is continuing to squeeze staffing levels and administrative budgets in a series of agencies. A prime example is the Social Security Administration (SSA), where the administration is in rapidly deteriorating disarray. A recently released GAO study (GAL/IMTEC-878) regarding the Administration's much vaunted systems modernization plan does everything but call that plan an unmitigated disaster. In some field offices, employees are forced to buy their own pencils and paper. "Short cuts", leading to higher payment error rates, are being implemented with abandon. The disability review process is about to seriously malfunction again. Long waiting times in offices and an inability to get through to SSA workers by phone have become the norm.

This fiscal year, the agency will have to implement two major statutorily mandated programs, the issuing of Social Security numbers to children over age five for tax purposes (9,000,000 above the number of cards normally issued). The SSA estimates that it will take 1,600 work years to effect this initiative. Immigration reform will also place an enormous burden on SSA. Four thousand work years is a moderate estimate. Also, the beneficiary population is steadily increasing.

And what is the Administration's response to the situation in its budget proposal? It is recommending a staffing cut of 5,092 from last year's Congressionally authorized level (74,437 to 69,345). It is seeking to increase the overall staffing cut in its long-range plan from 17,000 to 20,000 by 1992. Their budget proposal is a blueprint for disaster.

Mr. Chairman, our workers are proud of their contribution to this country's most important domestic program. But they can't properly serve the public without adequate resources-- Resources in terms of staff, adequate phone service capability, travel money to provide for public information campaigns and to take applications from the disabled, and ability to service SSA contact stations. And yes, enough money to provide for something as simple as basic pencils, paper, cellophane tape, and photocopying paper.

There are those who would like to see agencies, such as Social Security, fail. We ask that the Congress provide sufficient funding to assure that agencies not only survive, but can fulfill their missions.

Federal workers over the last six years have been on the defensive over their pay, retirement, health benefits, working conditions, and jobs. Positive, forward-looking legislation which addresses the unmet needs of federal employees has not even been on the schedule. It is time to get them on the agenda.

TESTIMONY ON THE FEDERAL BUDGET FOR FISCAL YEAR 1988 SUBMITTED ON BEHALF OF THE BUSINESS ROUNDTABLE

Submitted by: Robert D. Kilpatrick
Chairman and Chief Executive Officer
CIGNA Corporation, and Chairman
The Business Roundtable Federal
Budget Task Force

Submitted to: United States Senate
Committee on the Budget

March 1987

Mr. Chairman, Senator Domenici, Members of the Committee. I am Robert D. Kilpatrick, Chairman and Chief Executive Officer of CIGNA Corporation and Chairman of The Business Roundtable Federal Budget Task Force. Thank you for the opportunity to share with you once again our thoughts about the Federal budget deficit.

My basic message has not changed since I spoke to you last year; the passage of time and recent events here in Washington only make it more urgent. The Business Roundtable continues to believe the Federal budget deficit is the single most important economic problem facing the nation today. We continue to advocate reduced spending, above all other strategies, to solve the problem.

In December 1985, Congress and the President agreed that passage of Gramm-Rudman-Hollings was needed to cope with the deficit problem which many of us felt had reached a crisis stage. Last year, progress was made toward controlling spending and reducing the growth of the deficit. The percentage growth in Federal spending in FY87, compared to FY86, will be the lowest in more than 30 years. It is estimated that the FY87 deficit will be about $50 billion lower than FY86. That too is impressive.

On the other hand, the budget deficit is clearly not yet under control. The FY86 deficit set a record. It exceeded the Gramm-Rudman-Hollings limit of $144 billion by some $50 billion. The FY87 deficit will likely exceed the limit by $30 billion, or more. The structural deficit remains alarmingly high five years into economic recovery.

Judging from reports in the newspapers last week, the budget debate seems to consist of merely deciding whether to adhere to the Gramm-Rudman-Hollings target for FY88 or to abandon it. The Roundtable is truly disappointed to see Congress' energy consumed by an exercise in reducing expectations rather than the important work of reducing the deficit.

Obviously it is tempting to amend the Gramm-Rudman-Hollings targets, to make them easier to reach simply by bringing them closer. Many have suggested that this be done. My initial reaction is that such a strategy concedes the race before it is run.

First of all, given the tight budget timetable, Congress simply does not have the luxury of reopening the debate on the Gramm-Rudman-Hollings limits. That debate would only deflect you from the challenging task of bringing out the leanest possible budget for FY88. Every attempt should be made again this year to honor the Gramm-Rudman-Hollings limit. If Congress and the Administration agree on a package which reduces the deficit without recourse to false assumptions or gimmicks, you will deserve credit for a substantial step toward a sound budget, and you will have our support and appreciation.

Should your best efforts fail to hit the $108 billion target, it would then be time to rethink assumptions and goals. To do so today, before facing the hard choices that bring real budget cuts, invites the worst outcome of all: a reduction of goals in advance, followed by a reduction in resolve to meet those goals, and finally a deficit reduction even smaller than the $36 billion being discussed today.

This year, much of the Congressional and media attention usually given the budget deficit has shifted to our country's trade deficit and our loss of competitiveness in the world marketplace. For too long this problem has been the exclusive concern of economists. National debate on our declining competitive position is, in my opinion, overdue and welcome. The competitiveness issue touches on our technology, our labor force and our system of education, but those who would abandon the budget deficit debate to seek ways to restore our competitiveness misunderstand the problem. At the Roundtable we are persuaded that the competitiveness problem grows in large part from the budget deficit and we are sure that no lasting improvement in America's competitive status can occur until our budget difficulties are resolved.

Surely there is no question that our budget and trade deficits are closely related. Personally, I do not believe it is necessary to choose among economists' explanations of the relationship between the budget deficit, trade problems, and other indicators such as the value of the dollar. Paul A. Volcker, Chairman of the Federal Reserve Board, in his testimony before the Joint Economic Committee on February 2nd, described a number of recent marketplace events and concluded: *"Through it all, two disturbing (and partly related) currents run strongly — our trade and budget deficits."*

Look at just some of the effects of a large budget deficit on our international competitiveness:

- To fund the deficit, the government competes for domestic capital that, in other circumstances, would have been available for corporate capital formulation, thus fueling the growth and modernization we need to be competitive.

- The deficit creates a demand for ever-larger inflows of foreign investment creating economic uncertainties associated with the potential reduction of such investment, or worse, sudden disinvestment. Not since the end of World War I has the United States economy been so vulnerable to investment decisions completely outside our control.

- Likewise, the enormous amounts the government borrows abroad might well have been invested in other countries' economic expansion, increasing overseas ability to purchase American exports.

- A government in debt has little enthusiasm and less money for embarking on new projects, no matter how worthwhile. Should Congress agree on programs to stimulate certain industries or help retool older, less competitive businesses, coming up with funding will be that much harder in a deficit-dominated economy.

In his testimony to the Joint Economic Committee earlier this month, Paul Volcker said:

> *"In the current fiscal year, some significant progress toward reducing the extraordinary budget deficit appears to be underway. But as you well know, sustaining that progress will require still more difficult decisions this year, and for the years beyond. The Gramm-Rudman-Hollings targets have signaled your intentions, but more important than those numerical targets is specific action by the Congress to ensure that the deficit will in fact continue to decline year by year. Without that progress, it is difficult to see how we could manage to reduce the trade deficit — and with it the net capital flow from abroad — without jeopardizing growth, progress toward lower interest rates, and financial and price stability at home."*

Dr. Charles Schultze, former Chairman of the President's Council of Economic Advisers, told a symposium on the Federal deficit in January[1]:

> *"A quick back-of-the-envelope calculation suggests we are losing about one-quarter of one percent per year in productivity growth as a result of the deficit.*
>
> *"We sacrifice productivity growth because the money that is going to finance the deficit is not available to finance capital investment which in turn leads to increased productivity.*
>
> *"One-quarter of one percent may not sound like much, but bear in mind we have experienced about one percent per year productivity growth since the 1981-1982 recession. That means we are giving up about 25 percent of the productivity growth we might otherwise enjoy, because of these very large deficits. That is not an insignificant cost."*

The Roundtable feels strongly that whether the issue is trade imbalance or budget shortfall, our difficulties are summarized by this simple fact: we are living beyond our means.

To restore this country's competitiveness, there can be no more important or more obvious first step than to support you in reducing the deficit. We offer this prescription for both our budget and trade problems: we must keep spending in line with incoming assets and revenues.

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[1] Symposium on the Budget Deficit, Orlando, Florida, January 8-10, 1987. Sponsored by the Committee for a Responsible Federal Budget, AARP, ACLI, AT&T, The Business Roundtable, CIGNA Corporation, Eastern Airlines, The Food Marketing Institute, General Foods Corporation, GTE Corporation, The Kerr Foundation, and Oklahoma City University.

We at The Business Roundtable remain convinced that the deficit problem essentially is a spending problem. Despite a determined effort, Congressional action on the FY87 budget did little to cut spending substantially in future years. Asset sales, one-time revenue surges arising out of tax reform, juggling Federal payment schedules and other budgetary sleight-of-hand helped meet short term goals, but they did nothing to reduce overall government spending and may have negative budgetary effects in future years.

Baseline budget deficit estimates, which show the deficit declining in future years, are unrealistic. They assume uninterrupted economic growth and revenues growing with the economy, but they assume spending will not grow to keep pace with revenues. That combination of results would be a radical departure from past experience.

So another year has passed. The promise of Gramm-Rudman-Hollings remains, but it is as yet unfulfilled.

What can be done to fulfill that promise? What practical steps can be taken? Having said we at the Roundtable regard the deficit essentially as a spending problem, it should surprise no one that we would begin work on a compromise package by looking for savings from every function of the Federal budget.

Let's begin with the President's proposed spending cuts. We all know those cuts make up less than half of the President's deficit reduction package.

You and I might make different choices than the President proposes. It seems to me, however, that anyone who wants to prevent a specific Presidential spending cut has an obligation to come up with a substitute spending cut — not just to suggest raising taxes instead.

A budget in reasonable balance will require spending cuts far beyond those proposed in the President's budget. We at the Roundtable were dismayed when Congress and the President, in the process of enacting Gramm-Rudman-Hollings, exempted in whole or part many government programs from the sequester process. Exempting the most popular government programs from the law's effects, in our judgment, diminished the pressure to reach the kind of compromises needed to fulfill the original aims of the law.

We are disappointed that the Administration's budget does not attack spending more broadly. Defense cannot grow as fast as the President proposes. Entitlements cannot be sacrosanct. While there should be no further cuts in needs-tested benefits for the poor, even those programs should be examined for possible savings through increased efficiency and better management.

Eventually, Congress and the Administration will have to address the structural spending problems in non-needs-tested entitlement programs ranging from Social Security to the farm program.

We understand very well that the words "Social Security" send shivers up and down the spines of politicians in both parties, as well as at both ends of

Pennsylvania Avenue; however, we also understand arithmetic. We know you are less likely to solve the deficit problem if you refuse to look for savings in the largest domestic program in the Federal budget -- and that program is Social Security.

We understand moreover that Medicare, like Social Security, enjoys an almost sacred political status. No one really wants to face the need to slow the growth rate of Federal spending for health care, but again, the arithmetic is clear. We know that you cannot solve the deficit problem if you refuse to consider economies in the fastest growing category of domestic spending. Health care costs have grown more rapidly than any other domestic function since the enactment of Medicare in the 1960s.

I would never advocate under-funding the national defense. I worry, though, that some members of Congress would like to deal with the deficit problem principally by cutting defense. I don't believe it is possible to solve the deficit problem that way, certainly not without endangering our security and the security of our allies. Having said that, however, I believe defense spending needs to be considered as a source of savings. Defense restraint -- the reduction of redundancies and waste — must find its way into any credible package to move the budget back toward balance.

Today, we must find offsets for every new expenditure to meet the requirements of Gramm-Rudman-Hollings. Even if Gramm-Rudman-Hollings did not exist, we would be constrained simply by the size of the deficit we face. The United States must not become so harried by debt that we begin to doubt whether we can afford clean water, a strong national defense, generous retirement programs and adequate health care. It is within our means to determine our priorities for the future and seek them confidently, As part of that process, however, we must question past goals and present expenditures.

The nation's fiscal house must be put in order — not only because of the economic dangers posed by the deficit — not only because of the generalized economic benefits of deficit reduction — but in order to create an appropriate financial environment to consider new priorities on their merits.

A commitment to bipartisan compromise is essential if the deficit problem is to be solved. While the virtues of bipartisanship are still invoked in debate over the budget, they receive more lip service than real commitment. I think we need to relearn respect for the principle of bipartisanship. How else can government function with a Republican President and a Democratic Congress? How else can we solve problems as difficult as the deficit?

You, Mr. Chairman and Senator Domenici are to be commended for your several serious efforts to forge a budget compromise. Indeed, in August of 1985, many of us thought you had succeeded. We feel certain most of you share our regret for that lost opportunity.

To achieve compromise on the budget, everyone must be prepared to give up something — perhaps something precious.

At this point, some may ask what we in the business community might be persuaded to forego. That is a legitimate question. We at the Roundtable understand that before the budget is ultimately brought into reasonable balance, additional revenues may be needed. Let me point out, however, that business already has made a substantial contribution to a healthy fiscal environment. While recent tax reform may be essentially revenue neutral, it has not been revenue neutral for business. As a result of tax reform, we will pay more than $120 billion in additional taxes in coming years.

We have accepted last year's tax increases in good faith and as good citizens. Understandably, however, we are not prepared to talk about further business tax increases until Congress has demonstrated a willingness to take practical steps toward spending cuts.

If the package of solutions on the table includes real structural reforms in entitlements including Social Security, Medicare and farming; if the package includes reasonable restraint on the growth of defense spending; if the kinds of changes we believe are appropriate and necessary on the spending side are addressed courageously; you will find us reasonable and supportive.

My Roundtable colleagues and I do disagree, however, with the idea that Congress has cut spending as much as possible. We simply cannot accept that. Indeed, if we accept such a premise, then our nation would have to raise taxes by roughly 25 percent or accept very large deficits *ad infinitum*. Neither of those outcomes is acceptable. Neither would help restore U. S. competitiveness. Neither is consistent with long-term, non-inflationary economic growth.

So, to return to my starting point: the Federal budget deficit is our most crucial economic problem. It must be addressed forthrightly by accepting the need to cut spending further than we have.

The budget debate continues, while concern about our international competitiveness has arisen. They are and must be seen as related. It is our sincere hope that the competitiveness debate will be seen in part as a framework within which to seek and achieve practical deficit-reducing results.

We in the business community are prepared to do all we can to help. We remain optimistic that the compromise will succeed, because it must. The stakes are too high for us to fail.

Thank you for the opportunity to present a business perspective on this vital issue.

Statement of the Chamber of Commerce of the United States

ON: FISCAL YEAR 1988 BUDGET

TO: SENATE COMMITTEE ON THE BUDGET

BY: PETER M. FLANIGAN

DATE: FEBRUARY 5, 1987

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest federation of business companies and associations and is the principal spokesman for the American business community. It represents approximately 180,000 businesses and organizations, such as local/state chambers of commerce and trade/professional associations.

More than 91 percent of the Chamber's members are small business firms with fewer than 100 employees, 58 percent with fewer than 10 employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business--manufacturing, retailing, services, construction, wholesaling, and finance--numbers more than 11,000 members. Yet no one group constitutes as much as 29 percent of the total membership. Further, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the 56 American Chambers of Commerce Abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross section of its members serving on committees, subcommittees and task forces. Currently, some 1,800 business people participate in this process.

STATEMENT
on
FISCAL YEAR 1988 BUDGET
for submission to the
SENATE COMMITTEE ON THE BUDGET
for the
U. S. CHAMBER OF COMMERCE
by
Peter M. Flanigan*

February 5, 1987

The relentless growth of federal spending has been the chief cause of rising federal deficits. The frustration over repeated failures to solve this problem eventually led to a strong bipartisan effort that resulted in the passage of the Gramm-Rudman-Hollings amendment. Although some progress has been made, there is still cause for disappointment. Consequently, it is important for Congress to take advantage of the many opportunities for spending reduction and make substantial cuts in projected federal outlays. Anything less than this--and I include tax increases--will be ineffective and will jeopardize the economy's ability to grow.

Less than two years ago, the prospects for deficit reduction seemed grim. The Congressional Budget Office (CBO) had projected a path of rising annual deficits that climbed to over $300 billion by 1991. Today CBO is forecasting a more favorable path for deficits with the 1991 deficit, estimated to be $109 billion.

Although federal spending continues to grow, Gramm-Rudman-Hollings has led Congress to take some courageous spending reduction efforts. Congress has made significant reductions in defense spending growth and slowed the growth of nondefense discretionary spending. By avoiding a major tax increase, Congress also has improved the ability of our economy to grow and create jobs.

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*Managing Director of Dillon, Read and Company, Inc., and Chairman of the Economic Policy Committee of the U.S. Chamber of Commerce.

However, the major source of our deficit problem continues to be the spending side. Spending on major nonmeans-tested entitlement programs continues to escalate. For example, there have been no major attempts to make even modest changes in the Social Security program, such as a one-year cost-of-living adjustment (COLA) freeze. We believe that there are many of spending reduction opportunities in other areas of the budget. These include agricultural price support reform, privatization, program phaseouts and freezes, financial reforms, higher user fees, and fiscal federalism.

Missed opportunities for spending reduction are revealed in CBO's deficit forecast for this fiscal year. They project a deficit of approximately $175 billion, which is $30 billion over the Gramm-Rudman-Hollings target set for 1987. However, much of the overage could have been avoided if, for example, a more responsible farm bill had been crafted last year or if the 1987 budget sequester had been passed by Congress and signed by the President.

The Chamber believes that the President's budget for 1988 provides a useful framework for future budget deliberations. We applaud the President for proposing a budget that meets the requirements of Gramm-Rudman-Hollings with spending reductions and other program reforms. His resolve to avoid tax increases demonstrates his commitment to economic growth and freedom of choice.

However, we believe that the President's budget does not go far enough. For example, managerial efficiencies within the defense department should be pursued. Serious consideration should be given to trimming those "pork barrel" aspects of the defense budget, now that firmer limits are being placed on total defense spending. A one-year COLA freeze should be applied to nonmeans-tested entitlements. The median real income of the elderly has more than doubled since 1950 and, over the last 20 years, has risen faster than that of the nonelderly population. Fundamental agricultural price support reform also should be undertaken, because such spending is now approximately $26 billion or five times greater than the annual average for the 1970's.

I. Federal Budget Milestones

Less than two years ago, our prospects for fiscal discipline seemed rather dismal. At that time, the CBO had forecast an ominous path for federal deficits. According to CBO's official 1986 forecast, the baseline federal deficit was projected to rise to $302 billion by 1991.

Since that time, our prospects for deficit reduction have improved significantly, and much of the former skepticism has been modified. For example, according to the most recent forecast by the CBO, the baseline 1991 federal deficit is projected to be $109 billion. In other words, the projected federal deficit for 1991 has been cut by more than half.

Although we recognize that deficit forecasts are often tenuous and that $100 billion deficits are quite unsatisfactory, much progress has been made. Congress can take much of the credit. One major milestone was the bipartisan support that led to the passage of the historic Balanced Budget and Emergency Deficit Control Act or Gramm-Rudman-Hollings (G-R-H) and the much needed discipline that this legislation has injected into the federal budget process.

Congress has achieved savings by slowing defense spending growth, achieving economies in the nondefense discretionary portion of the federal budget, and enacting, in 1986, an $11.7 billion across-the-board sequester mandated by G-R-H. Other changes include termination of the General Revenue Sharing program, legislation enabling the sale of Conrail, substitution of housing vouchers for construction subsidies, and reduction of the Amtrak subsidy. As a consequence, federal spending growth has declined from its 10% average annual growth rate, between 1980-1985, to 4.6% in 1986.

In attempting to meet the G-R-H deficit targets, Congress has been wise in avoiding a significant tax increase. This has helped contribute to the third longest recovery in postwar history, which has created 11.1 million new jobs.

II. The Challenge Continues

Although Congress has begun to make some progress, much more needs to be done, particularly now that we are in striking distance of a balanced budget. In developing a budget resolution for 1988, it is important for Congress to continue to make substantial progress against federal spending.

The Chamber believes that the public prefers such a federal budget policy--that the public perceives that reducing the government's share of the national economy places more control over resources in its own hands. We believe that the public understands that such a policy enhances economic incentives, the role of the entrepreneur, and job creation and that such goals are fostered by policy of limited federal spending and moderate taxation.

In spite of recent budget economies, the fact is that the federal government has been a "growth industry." For example, federal spending as a percentage of Gross National Product (GNP) stood at 20.5% in 1979 but has advanced to nearly 24% in 1986. The obvious implication is that federal spending has grown faster than the growth of the economy. Since 1980 the real growth of federal spending has averaged 3.7% annually, much more than the real growth of the economy, which averaged 2.4%. Even during the first full year of G-R-H, 1986, federal spending grew slightly faster than the growth of the economy. In fact, if we extrapolate the modern historical trend of federal spending, federal expenditures as a percentage of GNP will approach 40% by the late 1990's, a level that will match the current high levels associated with many stagnant European countries.

Moreover, our deficit problem has not been due to a dearth of tax revenues. Today, tax revenues as a percentage of GNP (18.6%) are consistent with the long-run average. Since 1980 tax revenues have increased by $253 billion, an increase of 49%. However, federal spending has increased more, rising by $399 billion, an increase of 67%. This suggests to us that government spending is the chief cause of the deficit and that better control over outlays is the only solution.

III. Opportunities to Reduce Spending Growth

The opportunities for spending reduction have been well-known for a long time. Moreover, these cases are not instances of cutting programs for the sake of simply cutting the budget. Most of these are in programs that do not always meet critical national objectives or programs that are inequitable, inefficient, extravagant, or more appropriate for lower levels of government or the private sector.

Nearly every portion of the federal budget contains areas worthy of consideration. A veritable "bank" of these recommendations has been compiled by the CBO, the General Accounting Office (GAO), the Office of Management and Budget (OMB), the Heritage Foundation, the Brookings Institute, the Grace Commission, the Senate Committee on Finance and the U.S. Chamber. Together, they comprise spending reduction opportunities that exceed $100 billion in one year alone. A general outline of some of the key provisions is sketched below.

o Federal Retirement Reform Entitlements for the elderly, including Social Security, Medicare, and Civil Service pensions, have been the fastest growing component of the federal budget for the past 20 years, growing from $25 billion in 1966 to $317 billion in 1986 or from 18.5% of the federal budget to 32% today. The Grace Commission has estimated that today's retiree who lives a normal lifespan receives Social Security benefits of at least three times the combined value of employee-employer contributions plus interest. This translates into a real return on Social Security investment to current retirees that can range between 9% and 20%, depending upon the year of retirement. The next generation will not fare so well. They confront greatly increased Social Security taxes. According to some estimates, today's 20-year-old will receive 72 cents for every dollar that he contributes to the Social Security system. Civil Service and military retirement systems contain an even higher subsidy rate. Consequently, it is important that Congress implement reforms, such as a one-year COLA freeze. CBO also recommends further economies, such as limiting the increase in Social Security bend points and reducing benefits for federal workers who retire early.

The Medicare program also badly needs reform. The program originally was estimated to cost $4 billion by 1980. It actually cost $32 billion that year--an eightfold increase. Today, such expenditures are $70 billion. Even modest subsidy reductions can yield substantial savings. For example, according to estimates by the CBO, if Medicare premiums for physician services were raised so that individuals receive a 50% insurance subsidy instead of the current 75% subsidy, over $3 billion could be saved in 1988.

o Agriculture Reform There are few areas of the budget where so much has been spent and so little accomplished. Price support payments have vaulted to $26 billion in 1986, the highest in the history of the program. This is significantly different from the 1970's when annual outlays seldom exceeded $5 billion. Yet, the plight of the farm sector has worsened.

One major problem is that a great portion of these payments, over 40%, goes to the largest 15% of all farms, which have net incomes that exceed $75,000 a year. Even more bewildering, taxpayers have to pay farmers to cut production through acreage reductions, paid land diversions, and payment-in-kind programs. Even modest reforms, such as means-testing price support payments, could save in excess of $7 billion annually. A more effective approach is to phase out such subsidies and provide assistance for marginal farmers to find other opportunities.

o Fiscal Federalism The approach here is to return greater funding responsibilities to lower levels of government for local public goods. This would go far to reduce the cross subsidies that are involved when residents in one part of the country are forced to pay for programs that primarily benefit residents in a different location. It makes sense for lower levels of government to pay for such programs, because they generally run a budget surplus while the federal government confronts large deficits.

Such proposals as increasing the local match on federal funds, from its current 50% level, in mass transit could save billions. According to estimates by OMB, from 1970 to 1980 the use of public transit decreased from 8.9% to 6.4% of total work trips taken, yet federal subsidies grew by 2,150%. Rarely have so many paid for the benefit of so few.

o Privatization Congress should also take advantage of a relatively novel method to achieve spending reduction--privatization. The advantage of privatization is that public programs are not eliminated but shifted to the private sector. Privatization can take many forms, such as the sale of public assets and commercial activities to private interests, contracting out, and the use of vouchers. The President's 1988 budget, for example, includes nearly $6 billion in privatization initiatives and much more is possible. Great Britain's recent experiment with privatization has added over $20 billion to its treasury.

o Cost Shifting This approach shifts the cost of federal programs to individuals who presently receive large subsidies by using federal services. Examples include higher Coast Guard user fees, auction of the unassigned broadcast spectrum, greater fees for the use of inland waterways, and higher fees for recreational services.

o Defense Reforms Further defense savings can be achieved through managerial efficiencies, reduction of ineffective weapons systems, and the many recommendations by the Grace Commission, GAO, and CBO. For example, Congress should give serious consideration to the closure of unnecessary military bases and reform of the commissary system. The Grace Commission has estimated potential savings from these sources to be nearly $3 billion.

o Other Programs Reforms The federal budget is composed of many moderate sized programs. This has prompted some to say that the federal budget is a "Leviathan composed of Lilliputians." Nevertheless, spending reductions summed over this area can amount to a significant savings. In fact, simply freezing the nondefense discretionary portion of the budget, where most of these programs reside, could result in over $10 billion of deficit reduction in 1988.

Congress should consider some of these opportunities. For example, the Rural Electrification Administration still makes loans to rural electric cooperatives at the bargain rate of five percent. Until 1973 it made those loans at two percent. Amtrak revenues only cover 58% of operating costs, and the Amtrak subsidy amounts to over $30 per passenger. Many higher education loans and grants are made to students whose parents income is substantially in excess of the median income. The Maritime Administration's cargo preference program raises government shipping costs by $200 million annually.

o Financial Reform Finally, Congress should consider such reforms as loan asset sales. This would serve the goal of making apparent the huge subsidies imbedded in the $1 trillion dollar federal loan portfolio, thereby curbing program abuse. These sales also would produce a large increase in cash flow to the federal government. This can help meet short-run deficit goals at the same time that substantive program reductions are making cumulative reductions in out-year budget deficits.

The survey above is only a bare outline of the possibilities for spending reduction. Congress only needs to reduce the 1988 current services budget by approximately 4.5% to reach its deficit goal. We believe, in light of the opportunities delineated above, that this is a small price to pay for benefits obtained through a sound economy.

IV. Looking Toward the Future

As we look to the future, we must realize that reducing federal spending also has an important human dimension. For years we have been told that more public spending would solve social problems. More public spending was hypothesized to result in greater employment and to provide opportunities for the less fortunate.

However, mounting evidence from around the world suggests that we have gone beyond the point where spending could be helpful and are now in the range where serious problems have emerged. It suggests that more public spending has resulted in higher unemployment, slower economic growth, and diminished opportunities for all. For example, Europe in the 1960's and early 1970's boasted brisk economic growth. From 1965 to 1974, the Western European governments spent an average of 37% of their GNP and economic growth stood at 4.3%. However, government spending continued to accelerate from 1975 to 1984, rising to 47% of GNP and economic growth slowed to a paltry 1.8%. In human terms, the Western European economies suffered dramatic increases in their unemployment rates, averaging a stunning 152% increase in that 10 year period. The National Chamber Foundation is now embarking on a comprehensive study of this issue.

The emerging lesson is that, beyond a point, more public spending is dangerous to our economic health. The implication is that with more public spending there is a greater likelihood of establishing ineffective programs--programs that create more problems than they solve. And just a cursory review of the U.S. federal budget uncovers many such programs.

As a consequence, it is important for Congress to consider the human costs of wasteful federal programs--the net job loss and loss in economic growth associated with more spending. Such an assessment would allow Congress to separate the useful programs from those that are ineffective and inefficient.

Treating federal programs in this way can improve the human condition. Reducing expenditures on wasteful programs releases society's resources for more productive uses. This increases the net wealth of society through job creation and economic growth. Reducing such expenditures also makes it possible to achieve moderate levels of taxation. This allows us to avoid the tragic human maladies that are associated with heavily taxed societies, such as chronic unemployment and economic stagnation.

V. Staying the Course and the President's Budget

The Chamber believes that Congress and the President during the past two years have chosen the correct course in attempting to meet G-R-H deficit targets through spending reductions. It should continue the same course of reducing federal spending growth and avoid significant tax increases.

In our opinion, robust economic growth is a major prerequisite for deficit reduction. For example, according to estimates by CBO a 1% increase in real economic growth would lower the baseline federal deficit by $61 billion in 1991 -- the last year of G-R-H. As a consequence, we must make sure that we do not have a major tax increase, an action that surely would dim our prospects for economic growth and deficit reduction.

We should realize, by now, that a large tax increase may not reduce the deficit and may worsen it by diminishing economic growth. Unfortunately, the disincentive effects of taxation are rarely accounted for in budget analysis. However, these effects are important when one considers that higher taxes mean less growth, less income, smaller profits and, therefore, a smaller tax base. Moreover, higher taxes usually lead to more spending.

The major tax increases of this decade illustrate this point. The Tax Equity and Fiscal Responsibility Act (TEFRA) promised a $103.9 billion deficit in 1983 and an $83.9 billion deficit in 1984. These targets were never achieved, because the rate of growth of tax revenues actually fell and federal spending exceeded the budget resolution by a substantial margin. A similar experience occurred in 1984 in conjunction with the Deficit Reduction Act. Taxes were increased, but again the rate of growth of tax revenues fell and federal spending growth rose by nearly 10%.

Unfortunately, some are suggesting that we go in the same direction. They have proposed that the full implementation of the marginal rate reductions be delayed. However, we know from the experience of Economic Recovery Tax Act (ERTA) that delaying such tax rate cuts depresses economic activity until the reduction is fully implemented. Moreover, the 1987 transitional rate structure is not low enough to compensate for the economically damaging changes in the tax base, such as repeal of the investment tax credit, scaled back capital cost recovery allowances, and reduced capital gains exclusions.

A similar prognosis applies to other recent tax proposals. For example, one popular proposal is an oil import fee. However, econometric simulations by well-respected groups, such as Data Resources Incorporated and Wharton Econometric Forecasting Associates, document severe negative effects from higher oil import fees. They show that higher prices of oil lead to sharp reductions of economic growth and significant job loss.

For these reasons, the Chamber supports the goals of the President's 1988 budget. We applaud its resolve to reduce the deficit with spending reduction and to avoid tax increases. We also appreciate its awareness of the opportunities available for spending reduction. The administration has chosen some innovative and effective strategies for deficit reduction. These include privatization, increased user fees, agriculture reform, financial reforms, fiscal federalism, and phaseouts of inefficient programs.

Nevertheless, we believe that the President's budget can be improved. We believe that it is essential to go further in such areas as defense, Social Security, agricultural subsidy reform, and other entitlement programs. The inclusion of these items will create a greater sense of equity and shared sacrifice.

The Chamber is encouraged by the progress made in the last two years. We applaud the determination of many in Congress to pursue a deficit reduction strategy that relies entirely on spending restraint and other federal program economies. We recommend that Congress continue along the same course in the preparation of the 1988 federal budget. The benefit will be a future of sustained economic progress.